Are You More Disciplined Than an Eleven-Year-Old?

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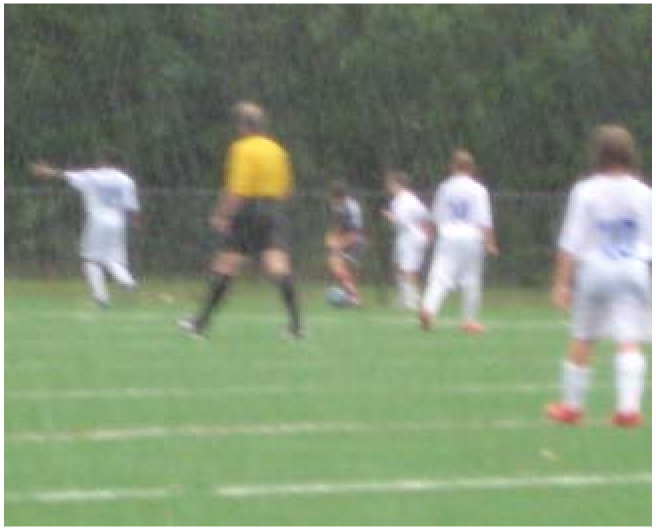
While being part of the soccer mom demographic has its undeniable perks, such as deciding the political fate of a large nation, there are a few disadvantages, often weather-related. My son's travel soccer team is now good enough to be challenged by clubs in other leagues, conveniently located in other states, so our weekends, already pre-ruined by soccer, are now ruined over much greater distances. Few people know that soccer etiquette rivals that of the protocol for dueling in the antebellum south, and games are only cancelled because of lightning or flooded fields.



A 1-0 loss completely unattributable to Tropical Storm Hannah.

We were looking forward to a pleasant country outing after being invited to play the Beachside Soccer Club in New Canaan, CT, until we discovered it was scheduled for the day Tropical Storm Hannah was expected to blow into town. Both teams' managers, in a game of "who is more macho?" refused to call the match. The first drop fell at kickoff. The wind knocked down the corner flags and the rain came down so hard even a rocket ship couldn't have lifted off, but the teams played on anyway. Both sides were disciplined in their tactics. A tropical storm was clearly not a good enough reason to lapse into sloppy play. And these are eleven-year-olds!

Just as the weather channel warned us to expect Hannah's arrival despite a day that dawned crisp and clear, stormy financial weather was not unexpected. We faced this quarter knowing that conditions were about to become acutely miserable, but that our team would have to play on, regardless. Regulators are frantically trying to cram the shadow banking genie back in the bottle, causing unpredictable swings in the market. The good news is that when Wall Street's problems become Main Street's problems, there's the political resolve to make unpopular and tough decisions. The bad news is that it all takes a while to sort out.

This quarter our small-cap composite was down 2.3% versus -1.1% for the Russell 2000, for a lag of 120 basis points. For the year the composite is down 13.1% versus -10.4% for the Index; we trail by 270 basis points. We got better results as the quarter progressed, gaining the most ground in September. Our top three stocks contributed 3.4%, but our worst three, all energy stocks, more than offset this, costing us 4.6%. The rest of the portfolio beat the Index, which is a good thing.

Sector exposure drove our relative performance more than is typical this quarter. Energy was the market's worst-performing sector, and our modest overweight hurt. Being underweight in financials helped or hurt by a 100 basis points or more, depending on breaking news and the

Composite returns are stated gross of fees. Please see Notes to Performance on the website.

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Street's mood on any given day. The Russell was down almost 8% in September, which while unpleasant, could have been a lot worse, as we've since found out so far in October. Since our inception in 1995, the Russell's two worst months were August of 1998 (down 19%) and July of 2002 (down 15%). Our relative daily performance did not bounce around as much back then, but then neither did the financials. See graph, next page.

As bottom-up stockpickers we like to parse individual stocks, but given the larger sector impact on our performance this quarter, we think it's important to share our thoughts on financials and energy. We have been systematically combing through the small-cap financial universe for months, but find little to get excited over so far. While in aggregate the financials look "cheap-ish," they are in fact a bifurcated universe: Well-run community banks whose earnings are rolling over with the credit cycle are trading well over 2.5 times tangible book, while the stocks of ultra-cheap problem banks have binary outcomes. They'll either go to zero or go up a lot, but are in the meantime unanalyzable (e.g., one day Fannie and Freddie Preferred Stock is investment grade, one day it's not, creating huge writedowns to bank capital base), causing us to pass, by invoking the life is too short rule.

In addition to the truism that an investor can never really value a bank's assets (the loans on its books) or the extent of an insurance company's liabilities (natural disasters are hard to predict), it's difficult for us to find underappreciated positive change in the rate of change in banks and thrifts. Their businesses are so much more influenced by macro factors like the yield curve that it's tough for us to add an analytical edge and make the case for 50% upside. We have always been underweight financials, and we've built our long-term record choosing to deploy capital in other sectors we've found more rewarding.

As for energy, we focus on companies trading at large discounts to their net asset values, or whose production growth we believe is about to accelerate. We own two E&P companies: Quicksilver (KWK), which is a gas producer, and Warren (WRES), which has mature oil cash cows in the LA basin and fast-growing gas assets in Wyoming. TETRA, the only oil service company we own, provides drilling fluids and well decommissioning services and is thus somewhat counter-cyclical. Supply and demand for gas is very local, but we believe fears of a gas glut due to large discoveries in the Haynesville shale are overblown. To exploit those finds crews and rigs have to be redeployed from other locales, a zero-sum game as there's no surplus of either at the moment. Historically, there's only a four- to six-month lag until supply adjusts to demand, and as we are already seeing companies cut their drilling budgets, expect better pricing soon.

As for individual stocks, we have added two new names, Questcor (QCOR - biopharmaceuticals) and Carter's (CRI - infant and children's clothes) and sold out of PharmaNet (PDGI - clinical services outsourcing), see pages 8-15 for detailed write-ups. The word we hear from Main Street (or should we say, Corporate Park Drive) is that Europe is slow to non-existent, and that the U.S. economy seized up in September. Expect reduced earnings guidance and a complete lack of desire on the part of companies to predict the future.

We are upbeat about seeing a number of fine, upstanding companies which we normally wouldn't be able to afford, come into our capitalization range. In these times the gap between the good, the bad and the ugly narrows and a portfolio upgrade is wise. We are busily sifting through the candidates. Decked out in ponchos and umbrellas we continue to play on, notwithstanding the torrential deluge, because we're certainly not going to let a bunch of eleven-year-olds show us up in the discipline department.

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These graphs compare Daruma's daily relative performance in September versus the worst market months of the Russell 2000 since our inception. The swings were more pronounced in 2008, largely driven by swings in the financial sector of the Russell 2000.

Daruma's Daily Relative Return Versus the Russell 2000

August 1998
Daruma -16.3%
R2000 -19.4%
Return Diff. +3.1%

July 2002
Daruma -13.5%
R2000 -15.2%
Return Diff. +1.7%

September 2008
Daruma -6.6%
R2000 -8.0%
Return Diff. +1.4%