Third Quarter 2009 Portfolio Commentary

When Lightning Strikes Twice

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We are delighted to report a successful quarter, with the Daruma composite up 21.9% versus 19.3% for the Russell 2000. Year-to-date the portfolio is up 34.1% versus 22.4% for the Index, a gain of 1170 basis points. We would normally lag during such a strong run-up, but we were helped this time by having two stocks get acquired, one in July (SPSS) and one in September (Perot Systems). As delighted as we are that strategic buyers saw the same value in these positions that we did, it's impossible to predict when lightning will strike again.

IBM Acquires SPSS

On July 28 (Daruma's 14th birthday!), IBM announced that it was buying predictive analytics software maker SPSS at a 42% premium, or $50 a share. We'd held SPSS for ten years, trading around the position. We were convinced of the huge opportunity ahead for the company as businesses sitting on rapidly growing mountains of data would need sophisticated data mining and modeling tools both to make sense of the data and to make better business decisions. SPSS had a clean balance sheet and a formidable, stable cash cow in its statistical software franchise. Over the years, less missionary selling was needed – customers began to realize how critical predictive analytics were to their business needs. The arrival of CFO Ray Panza also meant a renewed focus on operational and fiscal discipline, and the company was a more consistent performer for it.

Dell Acquires Perot Systems

On September 21, Dell announced that it was acquiring Perot Systems, the IT outsourcing company, for $30 a share, or a 68% premium. We bought Perot in April, as a result of all the research we'd done on Allscripts-Misys. There was huge demand ahead as the government allocated $36 billion to drive adoption of electronic health care records, as a means of reducing health care costs and improving outcomes. When we bought Perot Systems everyone hated it, even long-term shareholders. Earnings and sales looked like they'd stalled out, and the company was cheap, at 13 times forward earnings. The sell-siders who followed Perot weren't the same crew who followed the pure play Health Care IT companies, and at the time they were not focused on the bonanza that would befall Perot as the largest player in the Health Care IT outsourcing industry.

Volatility and Garbage Rallies

Though the Russell 2000 was up sharply in both July

(9.6%) and September (5.8%), we note that our daily volatility versus the benchmark (Daruma being up or down more than 1% relative) continued to decrease, with only two days meeting those criteria, and those were the days when the news about SPSS and Perot hit the tape. This contrasts with 25 and 17 days in the first and second quarters, respectively.

While the "garbage rally" continued in the quarter, it seemed to decelerate a bit. Stocks under $5 led the way, up 43.8%, whereas stocks over $20 were up a mere 12.5%. Those with market caps under $250 million were up 22.8%, whereas those whose market caps were over $1 billion were up only 14.4%. And yet the torrid pace of lower quality stocks (those with no earnings) seems to have slowed – yes, they're outpacing their brethren, but the gap is not as big as it was earlier in the year.

There's a lot of debate in small-cap circles as to the likely length of this rally. Historically they usually run out of steam by now, but then again, the more speculative names got crushed even harder than normal in this downturn, and so, one could argue, have farther to run.

Financials and Energy

While Financials (ex-REITs) lagged the index this quarter, up 15%, they were up in a sharp reversal from the first half of the year (-20%). As a result, given their 15% index weight, Financials (ex-REITs) contributed 2.4% to the Russell 2000, and only 0.6% to our quarterly return. Our two financial stocks, both reinsurance companies, have been good sector-relative performers year-to-date, but weren't participants in the Lazarus, back-from-the-dead small-cap bank and thrift stock revival.

Year-to-date, Financials (ex-REITs) are still down (-8%), but with follow-on after follow-on offering hitting the deal calendar and recapitalizing banks and thrifts, the rebound may well continue into the fourth quarter and throw them into positive territory for the year. We have our eye on a handful of candidates, but are waiting for the commercial real estate lending shoe to drop.

Energy did very well this quarter, up 30%. While there's a case to be made that enough supply is being curtailed through shut-ins to raise natural gas prices in the U.S., the long-term supply picture suggests a fairly narrow trading range. There's a lot of gas waiting to be released into the system at $6, and this will keep long-term prices in check. The late summer rally in energy prices doesn't seem to be supported by fundamentals.

Earnings and Wile E. Coyote

We can't predict exactly when investors will care that earnings expectations be met not via cost cuts but via sales growth, and there's risk that the top line does not kick in as scheduled, which would be bad for stock prices. Certainly the great global reliquification trend continues, as there seems to be no dearth of capital available to deploy in IPOs, financial services firms, or oil and gas companies. Crisis? What crisis? Stock prices have discounted a future that needs to materialize soon, lest they meet the fate of Wile E. Coyote, who finds that he is running on air just as gravity kicks in.

We are back to the tedious sifting for investment ideas, and from experience we know that when it's slim pickings, the market is ahead of itself. So we watch and wait for good entry points. Patience typically pays off. And maybe lightning will strike again.