Second Quarter 2009 Portfolio Commentary

Roman Candles and Bottle Rockets

By Mariko Gordon, CFA
Founder, CEO & CIO

We celebrated second quarter performance as well as Independence Day on July 4. We had a good quarter, with our composite up 22.8% versus 20.7% for the Russell 2000. Year to date we are now up 10.0% versus 2.6% for the Index, ahead by 739 basis points. We're pleased to have picked up relative ground **both** in the first quarter, when the market tanked **and** in this quarter, when the market rallied.

Beating the Index by 206 basis points in a market that was up 20% was cause for celebration, given that our value bias means we usually get left in the dust during sharp rallies. We lagged in the first two months of the quarter but had a tremendous June just as the market rally started to fade -- we were up 5.1% versus 1.5% for the month. Our top three performers for the quarter contributed 5.2%, while our three biggest losers cost us 1.4%, for a net of 3.8%. Nine stocks contributed over 100 basis points each, with fuse maker Littelfuse (LFUS), art auction house Sotheby's (BID) and healthcare IT provider Allscripts-Misys (MDRX) leading the way.

Tempered volatility

Last quarter we saw the volatility in our relative performance (as measured in days where we were +/- 1% or more against the Russell 2000) remain just as high as in the fourth quarter, though it was not as driven by Financials, which we took as an early sign of the market reverting to normal. Volatility in the second quarter confirmed that we could soon find ourselves in an environment where stock picking might once again matter. The number of days that Daruma's relative performance is +/- 1% or more has dropped to 17 from 25, and none were due to sharp moves in Financials. The volatility of our daily relative performance is mapped out for you at the end of the performance section. As our experience in June shows, individual stocks can once again drive portfolio results.

For the second quarter, Consumer Discretionary and Consumer Staples were positive contributors, while our technology stocks hurt relative results. Year to date, our overweight (coupled with good stock picking) in the Consumer Discretionary and our underweight in Financial Services helped performance. We are still extremely cautious about banks, and are picking through the wreckage very carefully, as it is a challenge to find banks that meet our cheap, changing, but not loaded-to-the-gills-with-toxic-assets criteria.

A slack tide

The market is in a slack tide, about to roll in one direction or another, but it's hard to tell whether the tide will be coming in or going out. A lot of companies beat expectations last quarter because of very aggressive cost cutting; going forward we need to see revenues grow in order to support stock prices. And while fears of a bankruptcy pandemic caused by a liquidity crunch have abated as companies have been able to float debt and equity, available credit is expensive and scarce. Investors are no longer discounting the end of the world, but it's too soon to say that happy days are here again across the globe. The news flow out of Washington, D.C., capable of whipsawing entire sectors, is also keeping us and other investors on our toes.

In the small-cap universe, the big winners since March 9 have been the low-quality stocks, as defined by stock price, beta, or low return on invested capital. Just as small caps do better than large coming out of a downturn, the smallest of the small lead the way out. Investors got so risk averse this last cycle that the low-quality names got punished far more viciously than normal, causing a ferocious rebound that's been hard to keep up with. The "garbage" rally has largely closed the gap in valuation since then, and the spread in performance between top decile and lowest decile quality stocks should narrow. This will favor portfolios of higher-quality companies, such as ours.

Increased turnover

Turnover, which as promised has picked up since the fourth quarter of 2008, continued this quarter. We bought six new positions and finished selling eight (four were initiated in the first quarter). The beauty of a concentrated, high-conviction portfolio is that every stock must earn its keep. New ideas put constant pressure on our existing holdings. We find that while our turnover ebbs and flows from quarter to quarter, over the long haul it continues to average 40% or so, and is solely a by-product of our research process.