

→ Second Quarter 2007 Performance Review

We Have Met the Enemy and He Is Us

– Walt Kelly, *Pogo*

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We logged another good quarter, up 9.83% versus 4.42% for the Russell 2000, for a relative gain of 5.41%. Year-to-date we are up 11.24% over the benchmark, at 17.69% versus 6.45%. The second quarter was similar to the first: each quarter had five stocks that gained more than 20% and six stocks that lost ground. In both quarters, we enjoyed a month when Daruma was up despite a down market.

Our performance tends to come in spurts, driven largely by stock selection, so while in the past we've also enjoyed periods of sizable outperformance, we know that gaining 500-plus basis points over our benchmark every quarter isn't sustainable. No matter the market environment, whether we beat or lag the index, we invest for the long term using our time-tested process. This quarter, performance was once again broadly distributed across the portfolio. Our top three stocks contributed 2.73% (versus 2.60% last quarter), while our bottom three cost us only 0.76% (versus 1.50%). We added one new position (SkillSoft) and sold three (Big Lots, Keane and Hot Topic). Because we want to ensure a proper margin of safety when buying a new position, we've been forced to forage harder after this market run-up. As a result we're sitting on higher cash levels, at around 8%. The second quarter reporting season should offer good buying opportunities, as the reality of a slowing economy collides with optimistic earnings estimates and extended valuations.

One of the more interesting things to take place during the quarter happened in Boston. Last month, I attended the CFA Institute's conference on The Efficient Market and Behavioral Finance. As a stock picker, I avidly follow developments in how human emotions affect financial decisions – after all, my life's calling is to exploit market inefficiencies. Successful investing, as I've come to learn, requires dispassionate and probabilistic assessments in an ever-changing context. But as the conference panelists illustrated with reams of data and brain scans, what worked for us thousands of years ago as hunter-gatherers is handicapping us as investors. We feel losses more keenly than gains (so we evaluate odds asymmetrically); we can't bear to stand apart from the crowd; and our short-term thinking is ruled by the emotional brain.

The single best defense against all this faulty wiring is a robust investment process. To my delight, steps in Daruma's investment process that we take for granted were panelist recommendations. We lay out a plan of action before each anticipated news event to immunize against emotional contagion (i.e. the Street's reaction). We set valuation parameters that allow us to ignore short-term "noise" and invest for the long-term. Rather than panic, we perversely delight in stocks getting whacked *for the wrong reasons* so that we can buy more (It's on sale! Time to stock up!). We don't mind going against the crowd and picking stocks shunned by Wall Street. And, to test the

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

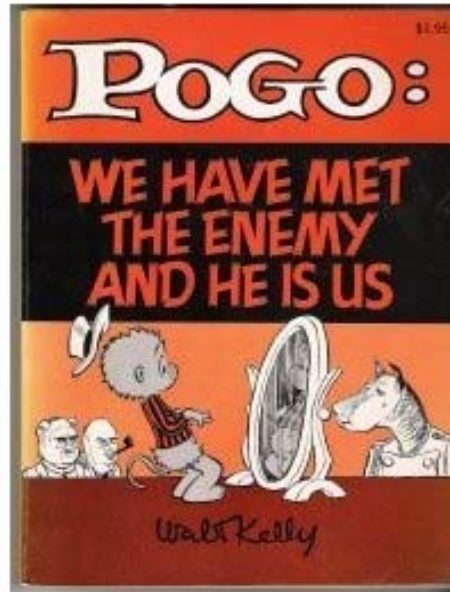
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robustness of our analysis, we look for evidence that would disprove rather than confirm our investment thesis.

At the conference, panelists confirmed that active managers tend to make good buys (based on analysis) but poor sells (based on emotion). One thing that Daruma has done for years is track the performance of our sells. We do this to hone our investment skills, not to self-flagellate if in hindsight we made the wrong decision. It's important to distinguish between a poor outcome despite a sound process and a poor outcome caused by a breakdown in the process. (For further insight, I recommend *The Halo Effect* by Phil Rosenzweig.) While we expect to make mistakes (it's an occupational hazard), we vow not to make the same mistake twice.

To this end, we recently volunteered to be a beta (test) site for Cabot Research, a firm that uses behavioral finance theory to spot patterns of self-defeating bias in portfolio managers. Cabot analyzed every trade we've made since inception. While Cabot expected its beta-site managers to fall into the same traps, every manager had a unique behavioral fingerprint. In our case, Cabot confirmed that we add alpha. With an annualized gross return since 1995 of 17% versus 10% for the Russell 2000, we must be



Doing something right. Cabot did have two findings: One is that while we make money buying “falling knives” (stocks that are declining) we’d make more if we stuck to falling penknives rather than machetes. The other observation is that, with our low-volatility, profitable positions that we’ve owned for less than our average holding period, we sell too early. As professional

skeptics, we plan to confirm Cabot’s observations by performing post-mortems on the stocks implicated in their study. This should give us additional and potentially valuable insights. I walked away from the conference eager to explore ways to enhance our probabilistic analysis and to learn more about how prediction markets (speculative markets focused on a variety of future events, including those that will affect stock prices) yield insights about portfolio holdings. We will continue to integrate the latest findings in behavioral finance into our investment process as applicable. We

have a culture of continuous improvement here at Daruma, and that means undergoing rigorous self-examination because self-knowledge is the best way to combat the enemy in the mirror.