



First Quarter 2010 Portfolio Commentary

Only the Paranoid Survive

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What's a money manager's greatest fear after a year of strong outperformance? Reversion to the mean. Just as the moon waxes and wanes, periods of outperformance are followed by underperformance. So we are especially pleased to have booked a good quarter after a great 2009, AND we did it the good old-fashioned Daruma way, through stock-picking.

Keeping up with the Joneses

We were up 11.20% versus 8.85% for the Russell 2000 - a relative gain of 2.35%. We earned most of that ground in February, and were pleased to continue to book a small gain in March even when the market took off (we were up 8.49% and the Russell was up 8.14%).

We are delighted that the market updrafts haven't clipped us on a relative basis as they often do. In the last four months in which the Russell was up 5% or more (July, September, and December of 2009 and March of 2010), we actually managed to beat the Index. This is unusual for us - given our emphasis on valuation, we tend to lag in sharply rising markets. In the 38 times the Russell 2000 has been up 5% for the month since our 1995 inception we have outperformed only 13 times. Thus we are especially pleased with the portfolio's results this quarter.

A quarter driven by stock picks

In contrast to last year when our sector weights helped us outperform, (being underweight Financials and overweight Consumer Discretionary), this quarter's performance was due almost entirely to stock selection. According to FactSet's attribution analysis, 100% of our return over the benchmark is due to selection effect (stock picks). With little help from sector weights, no takeouts, and no one stock giving us more than 150 basis points, our outperformance was of the highest quality.

Our top three winners were Sotheby's (auctioneer of fine art), Acxiom (direct marketing services), and lululemon athletica (yoga-inspired athletic apparel), giving us 406 basis points in total. All three were added since the 2008 market debacle. 4 out of our top 5 contributors this quarter were names added as we deliberately upgraded the portfolio in the darkest days of 2008/9. We have started taking profits in some and a few have been sold outright, but overall, we feel the appreciation has come from improving fundamentals and valuations are not too stretched.

Our top three losers were Synaptics (interface solutions for electronic devices), Lance (cookies, crackers &

potato chips), and Resources Connection (accounting & financial staffing firm); these were contained to under 100 basis points in total. We sold Synaptics, as market share losses have been faster and greater than expected, negating our investment thesis.

Too far, too fast?

With the Russell 2000 up almost 63% year over year and everyone feeling much better about the world, well-priced investment ideas have become scarcer. With the new idea bonanza quieting down, portfolio turnover has also settled down, as is typical.

Garbage rally losing steam

Last year the smallest, lowest quality stocks led the rally throughout much of the year. This trend seemed to stall out in the fourth quarter and since then we have welcomed more rational market conditions, conditions in which a stock-picker expects to excel. Volatility has continued to settle down, as shown by this chart of the RVX over the last two years.

There was only one day this quarter in which our daily volatility versus the benchmark topped 1%, and this



one was in our favor on a big down day in February. This compares to 25, 17, 2, and 2 days in the prior four quarters.

In the first quarter the low-quality stocks did lead again, but not by a wide margin, largely due to the rally in March. We expect the first quarter earnings season to

refocus investors on fundamentals. The move in the market needs sales growth to accelerate in order to sustain it.

We continue to slog our way through the usual mountain of news flow, earnings reports, and management team meetings as we look for the next Daruma stock. The beauty of a concentrated portfolio is that we should be able to find 25 to 35 companies worth owning, no matter how pricey the market.

We are working hard to keep the demons of regression to the mean at bay, and continue to build the portfolio one stock at a time, in the belief that every stock has to earn its keep if we are to continue to build on our long-term track record. ●