Third Quarter 2007 Performance Review

Outperforming for the Right Reasons

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

We are pleased to report that our small-cap composite was up 0.4% for the quarter, in contrast to a decline of 3.1% for the Russell 2000 — a difference of +3.5%. For the year, we are ahead of the benchmark by over 1500 basis points, at 18.2% versus 3.2%. By minimizing losses in specific holdings, paying close attention to total portfolio risk and striving to ensure that every stock earns its keep, we were able to sustain positive 2007 performance trends — despite the wackiness we endured in August. We were ahead of the index each month this quarter, but booked the bulk of our relative gains in July, when we were down a lot less than the Russell 2000.

No manager will quibble with beating his or her benchmark, but there is a right way and a wrong way to outperform. The wrong way hinges on chance. If we achieved great results because one or two stocks were skyrocketing or we had a cluster of buyouts — despite an otherwise listless and sagging portfolio — we would not be happy, and neither should you. Performance derived from buying merchandise wholly unsuited to our philosophy or a portfolio that violates our prime directive (cheap and changing for the better) would be similarly suspect. By contrast, the right way to outperform is repeatable — the outcome of skill more than luck. High-quality performance results from consistent implementation of a well-defined investment process.

Daruma's performance quality checklist

We use the same checklist to assess the quality of our returns, whether we outperform or underperform. Although we're beating the index now, Mr. Market guarantees that some time in the future we will lag, at which point we will go through the checklist once more to see whether we are underperforming for the right reasons — i.e., whether short-term underperformance means that we are sticking to (as opposed to straying from) our discipline.

Are our Top 3 losers in the normal range? Yes, if a tad better at -1.7% so far this year. Our Bottom 3 have cost us from -1.4% to -7% in a calendar year, or on average -4%, since inception. Losers are an occupational hazard, but minimizing their impact on the portfolio ecosystem is part of our job.

Is the contribution of the whole portfolio minus the Top and Bottom 3 besting the Russell 2000? Yes, the core of the portfolio is up 15.7% versus the Russell's 3.2%. Our best years occur when the portfolio in aggregate beats the benchmark, and we top it off with the net difference between our Top 3 winners and losers. We don't want to count on one or two big winners to beat the index.

Are our Top 3 winners in the normal range? Yes, albeit a touch light at 4% for the nine months. In any given calendar year, our Top 3 have clocked in at 2.8% to 12.4%, with an average of 8% since inception. Roaring bull markets help, but aren't strictly necessary to put up big Top 3 numbers.

Are the Top 10 positions within the normal range? Yes, at 38.9% of the composite portfolio. Our Top 10 positions have ranged between 35% and 40% of the portfolio. We're toward the high end of the range as many of our holdings have done well this year. Small price moves get amplified by position size, so we like to keep our Top 10 in check, and we carefully calibrate downside risk relative to position size.

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Lightning strikes in the form of a gaggle of buyouts? Nope. Nary a buyout this year. The Keane deal closed in April, but was announced in 2006. We are starting to feel insulted on behalf of our companies, spurned as they are by the private equity funds.

Unusual turnover? Nope. Our turnover during the last 12 months is on the low side, at 25%. The historical range has been 21% to 71%. Our highest turnover was during 1999, when we had eight stocks taken over.

Creep in the number of holdings? Nope. We had 32 stocks in the composite at quarter-end. We allow ourselves a range of 25 to 35 holdings, but in practice have 30 to 35 stocks in the portfolio.

Changes in average market cap size or financial characteristics of holdings? No, although with a concentrated portfolio averages can bounce around when only one or two of the holdings changes.

Any big sector tailwinds/headwinds driving results? No, although our relative performance benefited by 1.6% so far this year due to our underweight in interest rate-sensitive stocks (financial services, REITs and utilities). This contrasts with last year's headwind of nearly 7%, the largest in our history — one of those times when we underperformed for the right reasons, but it still hurt. In truth, we feel we're owed a bit more benefit given how much pain we felt last year! We usually expect to have to overcome headwinds of 2% to 3% from our typical underweight. Because we look for companies that are cheap and changing for the better, we often don't find enough candidates among financials, REITs and utilities. The Russell 2000 is stuffed with banks and thrifts, whose fate is determined more by macroeconomic trends than by management, so we find it tough to develop an investment case that's different from the Street's. Utilities, as regulated entities, often can't show the positive change in fundamentals that we are eager to exploit, and we do not invest in REITs as we consider them to be a separate asset class.

The bigger picture: Were all the humans on a coffee break?

So much ink has been spilled on the subprime mess and the meltdown of the quant copycats, that I also thought a peek at what actually happened to your stocks in the dog days of August would be instructive. I have never seen anything like it in 21 years of investing. Never have I encountered so many multi-dollar price moves up and down in the same stock on the same day for no reason.

We've seen previous glimmers of what came to pass in August. One day last year half our stocks traded half a day's volume at the open. Calling around only confirmed bizarre behavior in many other small-cap stocks, but no answers. From time to time, our trader, Steve Cohen, will notice large and illogical price movements in 100-share increments that we've chalked up to algorithmic trading gone awry, a foreshadowing of this summer. At the time we just thought the human operators had gone on a coffee break.

August 7th and 8th were days when some stocks looked as if they had jetpacks strapped on their backs, while others looked like they'd just had their throats slit. It looked like a Mr. Big or several Mr. Not-So-Bigs were all putting on the same trade at the same time. In retrospect, after reading several quantitative hedge fund client letters, our diagnosis at the time was spot-on. In any case, it's always better when individual stocks you know well act crazy than when a whole market doesn't make sense (March 2000, anyone?). Eventually, time heals all imbalances between supply and demand — and fundamentals inevitably reassert themselves.