

## → Fourth Quarter 2007 Performance Review

# A Bargain Hunter's Market

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*Founder, CEO and CIO*

For 2007, our small-cap composite was up 13.05% gross of fees versus -1.57% for the Russell 2000, a difference of +14.62%. Since our inception in 1995, our composite has delivered an annualized return of 15.97% gross of fees versus 9.25% for the Russell 2000. Since 1995 there have been four years when the Russell 2000 was down, and we were up in three of them. Not bad for a long-only, buy-and hold, relative return shop using no leverage and charging a fair fee.

There is a tremendous amount of fear in the market, and we are starting to see some truly irrational prices, which gladdens our bargain-hunting hearts. With history as our guide, we believe that, by the time we have definitive proof that we are in a recession, we'll be well on our way out. It's too easy to get caught up in a maelstrom of emotions and forget that a long-term investment horizon allows one to weather all sorts of storms. Perfectly predicting a pain-free entry point is a fool's task.

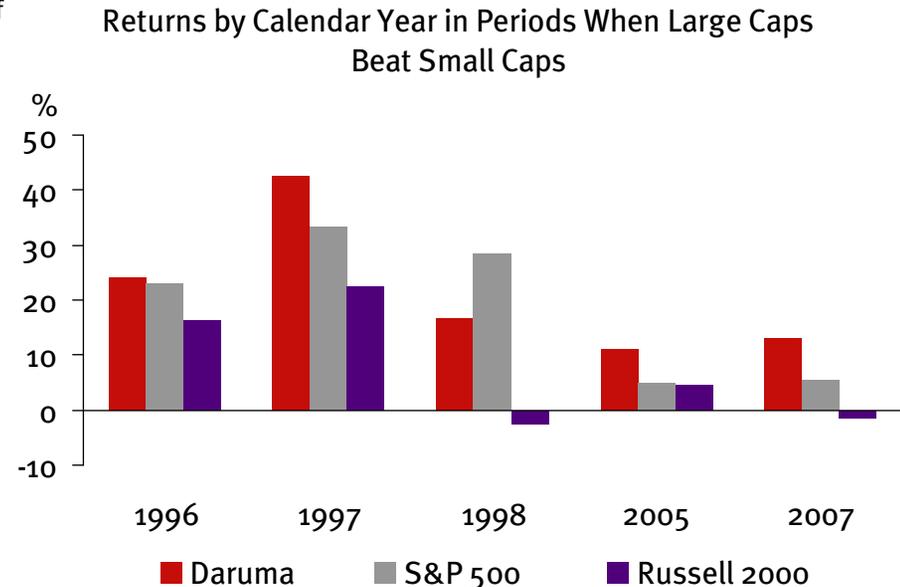
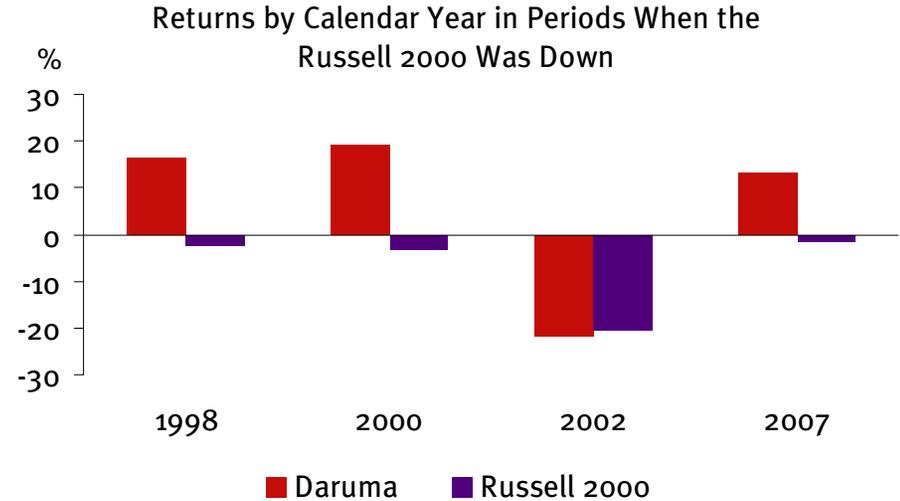
Daruma has fared well despite a shift by investors towards mega caps away from micro caps, and towards growth away from value. In over 20 years of investing I've lived through many such cycles, and each time I find that a concentrated portfolio of carefully picked stocks more than makes up for a lack of popularity in market cap size or style.

### Two Prevailing Misconceptions

We note two current misconceptions: (1) What appears to be a market favoring growth is actually one that is phobic about financials and besotted with materials and commodities, rather than a classic growth market driven by technology and health care. (2) What appears to be a



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



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market favoring large caps in part because small caps have less international exposure is really a market rejecting sectors that happen to be U.S.-centric, such as banks, thrifts, home builders and retailers. Small caps can have a great deal of foreign exposure and indeed the more they have, the better they've performed in 2007. We have plenty of foreign exposure: 74% of our holdings have sales outside the U.S.

One of our best-performing sectors in 2007 was consumer discretionary, which made up 3.72% of our 14.62% relative gain versus the Russell 2000. This is a testament to our stockpicking skill, as we were overweight a sector that was down 10.73% for the year, while our stocks in that sector were up 8.41%. Our typical underweight in interest rate-sensitive sectors contributed a mere 2.35% towards our relative gain, remarkably little given the financial sector's -16.7% meltdown in 2007.

For the quarter our composite was ahead by 22 basis points, as we were down 4.36% versus a decline of 4.58% in the Russell 2000. We had a strong October and November, but were hurt in December by stock-specific news. Diebold, the quarter's worst performer at -1.02%, was weighed down by news of a European competitor entering the U.S. market, exacerbating the decline in a stock already under pressure due to an accounting review. A controversial acquisition for Macrovision and a product launch delay for 3D Systems cost us -.85% and -.88% respectively. Our top three performers for the quarter — DeVry (+1.60%), PharmaNet (+1.26%) and Quicksilver (+.95%) — were also our best performers for the year.

Part of my task as steward of the portfolio is managing risk and making sure that we have a healthy mix of investment ideas at various stages in their lifecycle. With a concentrated portfolio, every stock has to earn its keep, and if we have too many big winners at once, we risk being top-heavy with expensive stocks. For most of the

year the appreciation in our best stocks was supported by superb earnings growth, but by the fourth quarter some of our positions had become too big and/or too expensive. It's difficult to sell winners and buy losers in a market that rewards relative price strength. Those stocks that are going up continue rising, and those that are dogs can't seem to find their way out of the doghouse. Still, in the long run, trimming or selling is the right thing to do, lest we indulge in the cardinal sin of not selling into strength.

So far our companies are complaining more about cost pressures than they are about falling demand. But everyone is nervous about employment, a credit crunch and a recession. Balance sheets by and large are in good shape. We keep a close eye on those holdings that took on debt to make an acquisition, having learned our lesson in 2002 about the perils of low-margin, high-volume businesses saddled with weak balance sheets.

A horrific macro environment hurts everyone, but, to quote the British poet William Ernest Henley, we focus on the companies that can claim "I am the master of my fate: I am the captain of my soul." Daruma has performed well in down markets precisely because we focus on companies that march to a whole rhythm section, rather than the sole drumbeat of the broad U.S. economy.

### **A New Year's Promise to Our Investors**

We will continue to build our portfolio stock by stock. We will continue to invest in no more than 35 stocks. We will buy only those stocks where we can clearly articulate why our perspective differs from the Street, and we promise to work diligently towards delivering good returns in 2008.