

→ First Quarter 2008 Performance Review

Watching the Tide Roll Away...

By Mariko Gordon, CFA
Founder, CEO and CIO

Pondering the first quarter of 2008, I think back to being a kid on the beach and finding masses of minnows stranded by the turning tide. I remember noting (as I madly scooped them up and threw them back in the water) how weird it was that fish didn't know how to swim out with the tide. That's how this whole financial crisis feels: liquidity crept up gradually, giving everyone lots of time to feed off the far reaches of the easy money beach, from "covenant lite" corporate loans to no-doc "liar's loans." The microscopic spreads between low- and high-risk instruments advertised that risk was all but free — the consequence of a rising tide of liquidity in an ocean of complacency. When the tide turned, however, it did so abruptly and quickly, leaving investors flopping on the wet sand. How could we forget that, like death and taxes, risk never disappears? Then again, how can fish forget to swim to sea?

Edging out the Russell

We edged out the Russell 2000, down 9.81% versus -9.90%. It was a tough slog. While we were up relative to the index in January and February, March saw us give most of that back, in large part because of the sharp snapback in financials, which we typically underweight.

Our top three performers contributed 2.12%, a terrific run rate in a lousy market. The bulk of our portfolio (top three/bottom three stocks excluded) beat the index by 179 basis points. In January, the worst month of the quarter (-9.17% for the Russell 2000), we outperformed by 79 basis points, thus extending our record of outperforming in big down months (-5% or more) to 20 out of 22 months since inception. Technology, the worst performing sector in the index, was down 18.32%, while our tech stocks were down a mere 3.16%.

We had six stocks that cost us over 100 basis points each. These were routine misses. In a market drained of liquidity and paralyzed by fear and uncertainty, however, small wounds fester. While a cluster of 100 basis point hits in this kind of market is not unusual, our three worst stocks cost us more than we'd like at -3.90%. Of the six, one missed big, one made a dilutive acquisition, one had a good quarter but lowered 2008 guidance, one had a middling quarter but lowered guidance, and two were leveraged and thus reduced to pariah status.

A buyer's strike

The market remains volatile. For the past few months it felt as though there was a long-term buyer's strike and a short seller's field day (thanks perhaps to the elimination of the

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



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uptick rule for short selling last July). It paid to sit on the sidelines as fear outmuscled greed and any buy decision was ipso facto a bad decision. The dearth of long-term buyers can be found in a short average holding period (six months!), short interest at a record high and the NYSE short-term trading index (TRIN) at levels not seen since 2002.¹ If you have the capital to deploy, and if you are willing to look beyond the next six months, this is an environment that offers many great buying opportunities.

And there is some good market news to report. We've had one or two up days that felt "real" on big volume suggestive of real demand rather than mere covering by short sellers burned by the Fed's rescue of Bear Stearns. There are some tentative, very early signs of stabilization in the housing market, and the government taking radical action provides an important psychological boost.

On Main Street, our companies report anemic U.S. results but good international demand, particularly in Asia (the weak dollar helps). As one CFO visiting our office put it "If you weren't reading headlines every day of things falling apart at the seams on Wall Street, you'd feel okay." In his company's experience, "We're not having a fabulous year; we're not having a horrible year, but a pretty normal year." It is critical, however, that U.S. employment not deteriorate, as employment remains the last underpinning of consumer spending.

Sitting on the dock of the bay...

Mammoth jackpot lottery winners have been shown to be no more happy than they were before they won — once the thrill wears off and one set of problems is traded for another. Everyone has an emotional set point (mostly hard-wired) we revert to once we get used to our radically changed circumstances, either good or bad. The market is no different — after all, it's made up of humans, albeit

with a few supercomputers thrown in. Once the world stops changing so fast and reaches a new equilibrium (even if the liquidity shoreline has permanently receded by a mile), investors can once again calculate the odds, and will once again make investment decisions. Thawing markets will allow fundamentals to trump fear, and as sure as the sun will rise tomorrow, greed will resurface. In the meantime, we continually seek to upgrade the portfolio, weighing each potential buy idea against what we own and arbitraging the opportunities available to long-term investors in a market focused on a six-month time horizon.



Can you spot the presidential candidate and the portfolio manager? Yes, Barack Obama (known then as "Barry") was one of my 420 high school classmates — Punahou Class of 1979. He wouldn't have been voted the guy most likely to run for President, but he was clearly smart and charming.

¹Source: Jefferies & Company. TRIN= (# of advancing stocks / # of declining stocks) divided by (advancing volume/declining volume)