

→ Fourth Quarter 2008 Performance Review

Been Down So Long It Looks Like Up to Me

– Richard Fariña

By Mariko Gordon, CFA
Founder, CEO and CIO

The title of Fariña's novel, a 1960s take on Odysseus's trials and tribulations, seems apt for the market we sailed through in the fourth quarter of 2008. Leaving aside the hallucinogens prevalent in the book's version of *The Odyssey*, the market required much portfolio heroism to stay afloat, from skirting the Scylla of rotting structured finance to dodging the Charybdis of plummeting commodity prices.

Daruma navigated the first two months of the quarter passably, but got left behind in the waning days of the year, with the Russell 2000 up 3.5% on December 31, goosing the index return for the month to 5.8%. For the quarter we were down 27.1% versus a decline of 26.1% for the Russell 2000. For 2008, we were down 36.6% versus a decline of 33.8% for the Russell.

Surprising small-cap financials

The small-cap universe did not mirror the drubbing that the money center banks and large investment banking firms took in 2008 (financials were down 57% in the S&P 500), and that accounts for the unexpected outperformance of small-cap stocks, with the Russell 2000 down 3.2% less than the S&P 500. In particular, banks outside of New York City (which make up a third of the financial services sector weight in the Russell 2000), were only down 11.7% for the year, a mere bagatelle in the 2008 market. Financials in aggregate were the third best performing sector in the Russell, down 22.7%, or much less than the index as a whole. The best performing sector was consumer staples, down 17%.



Can a place this beautiful truly harbor monsters? A view of Charybdis from Scylla, in the Straits of Messina, the putative location of our hero's nemeses.

For this reason our underweight in financials actually cost us relative to the Russell 2000 in 2008. True, our underweight in financials contributed 309 basis points for the year on an absolute basis. But being underweight the third best performing sector doesn't help when the capital that we didn't invest in financials got reinvested in market sectors that did worse.

Small-cap banks at risk in 2009

As we pointed out in the third quarter commentary, small-cap banks are not cheap. We are still of the opinion that the small-cap banks that escaped the residential mortgage meltdown (the big guys outmuscled them in that market) will take it on the chin in 2009 when they have to recognize commercial real estate losses.

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This commentary uses
small-cap composite data.

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Russell 2000 Sectors	Return (%)
Consumer Staples	-17.1
Utilities	-21.1
Financial Services	-22.7
Health Care	-27.7
REITs	-33.1
Materials and Processing	-35.7
Autos and Transportation	-39.1
Consumer Discretionary	-40.8
Producer Durables	-41.8
Technology	-42.2
Energy	-53.3
Total Return	-33.8

As you can see above, what capital we didn't deploy in financials we invested in other sectors that had lower returns in the index. Our stock picks in consumer discretionary and consumer staples did much better than their brethren in the Russell 2000. However PharmaNet (pharmaceutical services) and Symmetry (orthopedic implants) cost us relative performance in the health care sector, while our energy stocks all did worse than the index.

For every positive in our portfolio, there was a negative. In the plus column are the education stocks (DeVry and ITT Educational), and the actions we took in the portfolio: the net contribution of our new buys and our adds, and the net contribution of our sells and trims. The negatives include the aforementioned financial and energy sectors, in addition to individual stocks that had the temerity to miss earnings, require capital to grow, or be dependent on stable commodity prices to make their business models function.

In a year where the correlation among asset classes, sectors and stocks seemed to converge, investors did not distinguish among individual securities. Volatility was off the charts in 2008. Prior to September, the Russell 2000

had only three days up 5% or more (10/21/87, 10/30/87 and 04/18/00). Since September, there have been NINE such days. As to down days, there were eight days down 5% or more prior to September 2008, and THIRTEEN subsequently.¹

Wacky volatility

As volatility settles down, we expect that stockpicking will once again matter, and the market will go from 100% macro-driven to a balance between macro and micro factors. Our daily performance relative to the Russell 2000 continued to be volatile in the fourth quarter, whether in up months or down: 10 days in December had us plus or minus 1% or more relative to the index, while October had 12 such days. See the daily volatility charts on page 7. Most of those days are driven by large moves in financials.

It's clear that unlike prior slowdowns, inventories are very light – so much so that the supply chain will be highly sensitive to small increases in demand. There is a whopping amount of cash sitting on the sidelines – \$8.85 trillion or 74% of the market value of U.S. companies, the highest ratio since 1990.² Also, earnings preannouncements have been very heavy this season – this usually means that market expectations have been brought in line, possibly setting the stage for better stock performance.

Positioning the portfolio for 2009

Turnover has picked up as we take advantage of market turmoil to add high-quality companies to the portfolio. Rarely have we seen so many fine companies trading at such compelling prices; we have been waiting, in some cases for years, for some of these names to fall into our valuation range. We have also been encouraged by the positive performance of the stocks we bought in 2008, which have all performed well, contributing a total of 510 basis points to returns.

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We are adding a couple of reinsurers to the portfolio because they are (a) cheap and (b) the likely beneficiaries of better pricing due to both a decrease in capacity (reflecting the credit crunch, big storm losses in 2008, big investment losses, and the inability of hedge funds and private equity funds to provide capital) and an increase in demand (capital markets have all but shut down and reinsurance is the easiest way for insurance companies, especially mutual companies, to maintain their ratings).

We are also picking through the rubble of energy stocks, evaluating what we have against what's now available in our investable universe. We expect North American gas prices to recover fairly quickly, as gas is a local market. E&P companies have cut their capex budgets sharply in response to lower prices, and the number of drilling rigs has plummeted. The rig count is down 15% since September, and is still falling. As a lot of new wells have high initial decline rates, we expect production to drop rapidly, bringing supply in balance with demand. Oil may take longer to recover, as it will be more dependent on a global economic recovery.

We have positioned the portfolio in three buckets: (1) stocks with better earnings in 2009 than in 2008 (2) companies making improvements in their businesses that are masked by macroeconomic factors, but will be rewarded in a better environment, and (3) companies that are cyclical but will survive a prolonged downturn. While we haven't resorted to reading bird entrails as the ancient Greeks did, we are doing our utmost to track both macro developments as well as company-specific news in order to position the portfolio for future gains.

1. Furey's Insights, Furey Research Partners
2. Federal Reserve data compiled by the Leuthold Group and Bloomberg



Daruma of the Future. From the Dream to Dream exhibition at the Japanese American National Museum. Made by Charleston Hui aka "Chuckboy".

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A volatile quarter for daily relative performance: In October, there were 12 days in which Daruma gained or lost more than 1% relative to the Russell 2000. In December there were 10 such days. These were largely driven by the financial sector.

Daruma's Daily Relative Return Versus the Russell 2000

