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First Quarter 2009 Performance Review

A Two-Faced Market

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Janus, the two-faced Roman god of thresholds, new beginnings and changing circumstances, ruled over the start of 2009. The quarter was cleaved in two; before March 9th, the Russell 2000 Index had sunk 31.1%; the day after that through quarter-end, the index shot up 23.4%. For the quarter, Daruma's composite was ahead of the Russell 2000 by 460 basis points, down 10.4% versus -15%. We racked up a lot of relative performance early in the quarter, when small-cap financials finally broke down and drove the index lower, and we gave up relative ground in the March rally.

Volatility a constant
Whether bull or bear did not matter when it came to volatility, as the market was exceedingly volatile throughout the quarter. The difference between the intraday high and low for the Russell 2000 was more than 1% for *every* trading day in the quarter. It was greater than 5% for 13 out of 61 of the quarter's trading days. The small-cap version of the VIX, the Russell Volatility Index (RVX), is down off its peaks but is still at more than double its normal levels. Daruma was +/- 1% relative to the Russell 2000 on 25 out of 61 days (40% of the time). Unlike the fourth quarter, though, our relative volatility was not always due to financials, which suggests a return to a more normal market environment.

Looking back on the financials
What a difference a quarter makes. Small-cap financials were surprisingly resilient last year, down only 22%, whereas the Russell was down 34%. Small-cap banks, roughly 40% of the sector weight, were down only 12%. In this quarter, the financial crisis finally caught up with small caps, as Financials were the second worst performing sector in the index, down 25.3%, with only autos faring worse, at -28.2%. Small-cap banks were down 34.2% in the quarter. As we had suspected, small-cap banks weren't immune from deteriorating credit, rising charge offs, and construction/real estate loans gone bad.

Looking forward to growth
Growth was clearly in the driver's seat for the quarter, with Technology and Consumer Discretionary the top two performing sectors in the Russell. The Russell 2000 Growth Index beat the Value Index by almost 1000 basis points, at -9.7% versus -19.6%. In the Russell 2000, Technology was down only 1%, while Consumer Discretionary was down only 5%. Improving consumer confidence and early signs of a stabilization in the housing market helped investors focus on the glimmers of light at the end of the recession tunnel. It is typical for the smallest of the growth small-caps to lead the way out of a bear market, as investors switch from playing defense to being more aggressive and willing to take on more risk. Both faster-growing companies and the smallest of the small-caps have done very well in this rally—it remains to be seen if they are harbingers of better times ahead for investors. It's tough to keep up when the smallest, highest-beta stocks are on a tear, so we are wary.

Good winners and moderate losers
We were especially pleased that the net of our top three contributors (Macrovision, ITT Educational and Shutterfly)

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minus our top three detractors (Snap-on, American Reprographics and Wabtec) was a positive 10 basis points. Normally in such a lousy, down 15% market, we'd expect our worst stocks to overwhelm our best stocks, and thus for the outliers in aggregate to detract from performance. The balance of our portfolio handily beat the index, down 10.5%. As you know, given a concentrated, no more than 35 stocks portfolio, we aim to have the bulk of the portfolio beat the index, with the net of our best three/worst three stocks being an added dollop of performance. Every stock counts and we invest with the expectation that every stock will earn its keep, knowing full well that losers are an occupational hazard.

We completed our positions this quarter in Aspen and Validus, two reinsurance companies, expecting them to benefit from hardening rates. We also added to the portfolio Allscripts, a health care information technology company that will benefit hugely from the stimulus bill, and United Natural Foods, a natural and specialty foods distributor. We made room by finishing up our sales in Questcor, Symmetry, Epicor, TETRA and Warren Resources.

Market musings
Some further observations on the market:

We saw some real buying occur in March, with the return of large programs hitting the tape late in the afternoon, especially of financials. Even during the first two disastrous months of the year, small-cap stock after small-cap stock didn't go anywhere near its previous low in late November.

According to Michael Painchaud of Market Profile Theorems (a very thoughtful data source we've subscribed to for years), the normal ratio is 2 to 1 insider selling to buying. In the three weeks just before March 9th, the sell to buy ratios were a very aberrant .63, .49 and .39. While insiders are still bullish, they are much less so following the sharp rally in March.

Small-cap mutual funds saw net inflows, and hedge fund redemptions were better than expected. There is still an awful lot of cash on the sidelines.

One thing we're keeping a close eye on as we head into earnings season (wearing flack jackets, as it's bound to be a very ugly one), is corporate bond spreads. Bonds are signaling more economic pain ahead, which may squelch investor appetite for equities.

A volatile market requires us to be nimble: One day a sizable market cap noses into our cap range ($2 billion and under), three days later it's up 40% and solidly out of range. We strive to keep a balance between being opportunistic and moving quickly when necessary, while making sure we do the requisite due diligence our process requires. We've heard that a number of firms have cut their research and travel budgets—not so at Daruma, where we will continue to hit the road in pursuit of new ideas. We continue to invest in our performance future, as always.