



Fourth Quarter 2009 Portfolio Commentary

Take Me Home, Country Roads

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We had serious fears of being left in the dust in 2009, given our experience after 2002's melt-down, when we lagged in 2003's massive rally. While small-caps typically roar out of a recession, they often do so in a way that makes it hard for us to keep up. The smallest, most speculative of the small-caps tend to snap back the strongest after having been crushed the worst. So we are especially delighted to report that we had an excellent 2009, with the small-cap composite up 43.93% versus 27.17% for the Russell 2000 Index. Daruma beat the Russell 2000 in every quarter and in nine out of the 12 months, which makes 2009 a year to remember. It was our fourth best relative and our best absolute performance year since inception in 1995.

A quarter driven by stock selection

We were also pleased with the fourth quarter, where the Daruma composite was up 7.14% versus 3.87% for the Index. Most notable was that we kept up with the market in December, up 8.15% versus 8.05% for the Russell. Usually those end-of-year rallies leave us coughing by the side of the road.

Our performance in the quarter was driven largely by stock-selection. While Financials (in which we are underweight) were the worst performer in the Index for

the quarter, their underperformance wasn't dramatic enough to help us. We had better-than-benchmark returns in Consumer Discretionary, Producer Durables and Technology, areas in which we also had our best stocks. Our biggest winner was data provider Acxiom, followed by yoga retailer lululemon athletica and auctioneer Sotheby's. Our detractors were Advantage Oil & Gas, ITT Educational and Carter's. One thing to note in the quarter was the fading of the garbage rally.

Stock picks and sectors helped 2009

For the year much of our 1670 basis points of outperformance came from picking good stocks and being overweight in sectors that did well. We were most overweight the best performing sector in the Russell 2000, Consumer Discretionary (+63%), and were underweight in the worst performing, Financials (-.09%). We had five positions each give us over 300 basis points of contribution, only one of which was a takeout. Another three stocks gave us over 250 basis points each. We also benefited from two takeouts, SPSS (a long-term holding bought by IBM) and Perot Systems (a position held for only five months bought by Dell).

Babies and bathwater

Earlier in the year, when the world was falling apart, we



made the conscious decision to upgrade the portfolio. On the one hand, we felt like little kids under a piñata scooping up the choice candy being whacked out of the market and falling into our market cap range. On the other hand, we knew that getting rid of merchandise when there's nothing but a glut of sellers means that beggars can't be price choosers. Yet it's the stocks that get pummeled the worst that snap back most fiercely.

Still, one unwritten rule in investing is that when they're throwing the babies out with the bathwater, grab the babies. They'll grow up into fine human beings some day. The behavioral finance gurus at Cabot Research who keep score for us by tracking the relative performance of all of our buys and sells confirm that the purchases we made in 2009 added way more value than the contribution would have been had we held onto the stocks we sold. By three to one!

The garbage rally fades

Our stock selection and overweight in sectors that did well was enough to not only keep up with, but beat, the garbage rally. After a brief flare-up in December, the garbage rally has started to fade again, but the

portfolio has continued to behave well, now that quality is starting to matter once again.

Forecasting the future

One client has told me that when asked to pontificate on the market's future, I always say, "On the one hand this, on the other hand that." Even though people like to hear precise forecasts said with confidence, I prefer to acknowledge that the world is a complex, ever shifting place, and that the range of outcomes is in constant flux. There are things that could break better-than-expected and take the markets up, and there are lots of things that could sink the ship.

There's a lot to worry about on the macro front: the withdrawal of economic stimulus, the remedies that feel duct-taped over cracks, rather than making the necessary structural change, the political inanities, the global world order careening into chaos. What we can see amidst our stockpicking weeds here in the middle of the small-cap pond is that the world is not feeding us carp with easy ideas, and that we're having to work hard for our supper.

Keep regression at bay

The downside to having such a fabulous year is that the specter of regression to the mean starts to haunt a portfolio manager's dreams. As surely as the sun will rise tomorrow, outperformance will inevitably be followed by underperformance. That is where the beauty of having an investment process focused on finding the fat pitches – those stocks for which we can make an investment case for 50% appreciation over a two-year period with a three to one upside/downside ratio – helps. No matter the environment, no matter where we've come from, no matter where the market is headed, we build the portfolio one stock at a time. We promise to make every effort in 2010 to keep the demons of regression to the mean at bay. ●