Fourth Quarter 2010

Three Markets for the Price of One

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Daruma Small-Cap

From 30,000 feet up, our 2010 performance may suggest a smooth and turbulence-free ride: Our small-cap composite was up 32.12% versus 26.86% for the Russell 2000, for a relative gain of 526 basis points. Down on the ground, however, where the speed bumps, detours and potholes reside, 2010 was about putting pedal to the metal when the road ahead was clear, but breaking from the speed-crazy pack when the fundamentals of navigation didn't support such excess.

Our quality approach rewarded us for the year but, as is often the case in a "garbage rally," led to disappointment for the fourth quarter, as the composite clocked in at 13.16% versus 16.25% for the Russell 2000, lagging by 309 basis points.

Quality blues in the fourth quarter

Though disappointing, we often lag in a sharply rising market. The Russell was up all three months, exiting the year with a bang; December finished up 7.94%. We lagged in October (224 basis points) and in December (116 basis points), while eking out a relative gain in November (59 basis points). Like a studious teenager whose partying friends suggest we come along for the ride on the logic of "what harm could it do?", it's not easy to sit at home when the fun is being had.

But a low-quality rally is a low-quality rally, this one led by those stocks with low share price, low market cap, low return on assets, and high beta. This was a reversal from the third quarter when it looked like investors were starting to differentiate between dross and gold. Some of this reversal may be due to inflows into small-cap ETFs, which tend to drive the lower quality stocks disproportionately. Our portfolio's ability to keep pace in this reversal simply faded.

While our top three winners offset our top three losers in the quarter (contributing a net 231 basis points), in every month the rest of the portfolio couldn't muster enough oomph to beat the Index. We had one stock (99 Cents Only Stores) that cost us 74 basis points in the quarter and only two others that dinged us, by a mere 17 and 9 basis points respectively. In short, our underperformance was not caused by big misses. Rather, the Index was powered by a low-quality rally and by the most economically sensitive and commodity-like industries in which we were underweight.

Repeat winners and stock selection boost 2010

We had 14 stocks contributing over 100 basis points for the year, five of which contributed over 200 basis points: yoga apparel company lululemon athletica (286 basis points), art auction house Sotheby's (282 basis points), electronic programming guide provider Rovi (259 basis points), photo products and services company Shutterfly (256 basis points), and carpet tile maker Interface (235 basis points).

All of these positions were either initiated or substantially added to during the great market meltdown of late 2008 and early 2009. Of these, Rovi, Sotheby's and Shutterfly were also among our top five winners at the end of 2009, proving once again that changes in "the world as we know it" are often market opportunities for those who stick to their investment discipline.

In contrast, we had just one stock detract more than 100 basis points in 2010: employment firm Resources Connection (118 basis points), which we sold.

Stock selection gets the credit for terrific returns in Consumer Discretionary, Health Care and Technology. Our performance in Consumer Discretionary in particular, thanks to senior research analyst Brad McGill, was superlative, contributing over a third of our performance.

Though Financials underperformed the Index for the year, they started to feel their oats in the fourth quarter. As the yield curve steepened, banks and thrifts rose in expectations of a wider net income margin. It's challenging for us to find "Daruma stocks" in an



industry group that moves in lockstep largely due to macro factors, because a differentiated point of view is harder to come by. The primary culprit was REITs, which we don't own and which contributed 205 basis points to the Index. If Financials continue to rally we will have to contend with those headwinds, as we are typically underweight in Financials, REITs and Utilities.

As to Energy, which ripped in the quarter as oil prices made new highs and in expectation of an economic pickup, our Rodney Dangerfield of a Canadian oil and gas company, Advantage, though up, still got no respect. Advantage is a well-run company sitting on gigantic reserves of low-cost gas, and its time will come. Our small underweight also hurt relative to the benchmark, given that the sector returns were up north of 30% for the fourth quarter.

David versus Goliath

It's been a hell of a 10 years for small-cap investing, having beaten the big boys every year save two (2007 trailing by 706 basis points and 2005 by a mere 38). There's a case to be made that small caps are more expensive than their larger brethren, and that the gap between their growth rates is shrinking. The higher growth rate of small caps being what justified their valuation expansion and relative performance, this makes sustaining outperformance difficult. After all, that kind of cognitive dissonance does not last long in markets. In prior periods of large-cap outperformance we have been able to beat the S&P 500. Knowing that it's possible, we will do our darnedest to do so again, should the no-we-can't-deny-it's-long-in-the-tooth-cycle turn in favor of the behemoths.

Daruma SMid-Cap: An Auspicious Start

We're off to a good start in the SMid-cap composite, up 17.82% versus 10.77% for the Russell 2500, since inception (4/30/2010), for a relative gain of 705 basis points. We were up relative to the Index in every quarter. For the fourth quarter we were ahead by 146 basis points, up 16.32% versus 14.86%. Good stock picking was responsible for 2010's results, and notably in the fourth quarter when our top three winners drove performance.

Good fourth quarter results

Our top three winners (employment solutions provider Monster Worldwide, micro-controller supplier Atmel and maker of floor and ceiling products Armstrong World Industries) contributed 487 basis points to performance. Our top three losers (discount retailer 99 Cents Only Stores, data storage equipment maker Brocade and silicon wafer manufacturer MEMC) cost us 116 basis points. Performance hinged on the net contribution of our top and bottom three, as the rest of the portfolio had trouble keeping up with the Index's rally. We'd prefer to have the entire portfolio beat the Index and then have an added boost from the net contribution of our winners and losers, but we'll take the victory lap anyway.

The most economically sensitive sectors had the best results, with Energy the star sector for the quarter, up over 30% for the Index, driven by coal and crude producers. Materials and Processing (up 17.05%), Producer Durables (up 17.58%) and Technology (up 18.15%) moved in lockstep higher. Slower growth sectors like Utilities, Financial Services and Consumer Staples lagged the Index.

Results were helped by the buyout announcement of J. Crew, which contributed 97 basis points, as well as two large one-time dividends paid by Armstrong World Industries and Internet domain registrar VeriSign, which contributed 113 and 47 basis points respectively.

As you know, we have a rule that there will be no more than a twelve stock overlap between the Small and the SMid portfolios. We sold Acxiom out of the SMid in order to make room for a new idea.

A successful 2010 launch in rough waters

Our top three winners (Atmel, electronic programming guide provider Rovi and database software maker Sybase) contributed 706 basis points, while our top three losers (slot machine maker International Game Technology, Brocade and small business marketing products purveyor Vistaprint) detracted a mere 176 basis points. The net contribution of our outliers was a healthy 530 basis points. The rest of the portfolio beat the Russell 2500, generating 12.68% in contribution, versus the Russell 2500's 10.77%. That is our goal: To have our best stocks generate a healthy dollop of performance, to minimize the damage done by our dogs (they are an occupational hazard, after all) but most importantly, to have the entire rest of the portfolio earn its keep by beating the Index.

We had seven positions contribute over 100 basis points each to performance, the biggest of which was Atmel, clocking in at 352 basis points in contribution. Our biggest loser, International Game Technology, cost us 66 basis points.

Terrific stock picking in Financial Services, Health Care, Materials Processing, Energy and Technology really drove returns.

Though financials in the Index underperformed for the year, they started to feel their oats in the fourth quarter. As the yield curve steepened, banks and thrifts rose in expectations of a wider net income margin. It's challenging for us to find "Daruma stocks" in an industry group that moves in lockstep largely due to macro factors, because a differentiated point of view is harder to come by. If banks and thrifts and REITs continue to rally we will have to contend with those headwinds. Though we did a superlative job in Financial Services in 2010, it was not due to stocks in those industry groups.

Overall, 2010 felt like a three-headed hydra – the first third marked the end of the "garbage rally"; the second saw quality matter in the market sell-off; and the last third was a beta-driven rally benefiting from QE2 (Quantitative Easing Part II, not the monarch) and expectations of a tick up in global growth.

The shape of things to come

Notwithstanding good 2010 results, we're headed for our least favorite part of the market cycle.

We are now in a market that is rewarding momentum and we are having to sell as our winners become too expensive, too risky, and too big in position size. Yet because the market as a whole is on a tear, we find no broad swatches of stocks that are on sale; where we find value we find zero momentum. It's like trading in Seabiscuit for a donkey – you may feel dumb at first, but if the road ahead is of the rocky cliff-face variety rather than a smooth race track, you know that sure footing will prevail.

These cycles occur over and over and, despite our track record of successes through them, are frustrating. Momentum stocks in a late-stage market environment are like Icarus: They soar until they get too close to the sun and the subsequent plunge is deadly. It's always tempting to strap on a pair of wings and fly as well, but we'd rather stick to our sell discipline.

While new ideas are not raining down, we are finding them, albeit through a painstaking, one-stock-at-a-time process. As value-oriented stock pickers, we almost wish for another end of the world scare, with its accompanying deluge of cheap, high quality stocks. (I did say "almost.")

Other than a dearth of new ideas, there are some other worrisome trends. For one, insiders are looking very bearish across the board. (A curious side note is that in last summer's debacle, Russell 2000 insiders stepped up and bought; S&P 500 insiders did not.) In addition, earnings momentum is decelerating, and that does not bode well, especially when coupled with current valuations.

In terms of structural supply and demand, we have conflicting forces. While small-cap insiders may not be putting their own money to work, they are deploying their firms' capital via stock buybacks and mergers and acquisitions (M&A) – the number of deals in 2010 exceeded that of 2008 and 2009 combined. To be fair, in such deer-in-headlights-inducing environments like '08 and '09, companies hunker down and hoard cash rather than invest in a bleak, unpredictable future, so the better M&A calendar in 2010 may not be that big a deal. M&A contributed 250 basis points to the Russell 2000's performance and 244 basis points to the Russell 2500's performance. We benefited from this trend in the fourth quarter, when apparel retailer J. Crew announced that it was being bought out by private equity in partnership with CEO Mickey Drexler. A number of our holdings have made both strategic and tuck-in acquisitions in 2010, which have been largely well-received by investors.

Mutual funds are holding little cash, which historically is not a sign of continued happy times, as a source of buying power is tapped out. The deal calendar was very strong as well, with 126 companies coming public, raising $30 billion in capital, and 540 companies raising over $100 billion in secondaries. This has also absorbed capital, leaving less investing powder to be deployed.

On the plus side, retail investors, having shunned equities in favor of bonds, are starting to flock back to the stock market, having been dealt some serious pain recently in fixed income land. This, of course, is another age-old story: Money flowing into small caps after the Russell 2000's back-to-back years with returns of over 25%. As pointed out previously, some of this money is going into ETFs, which, while giving quality-loving fundamentalists like us heart palpitations, fuels the Index higher. If this trend continues or accelerates, it will replenish cash levels held by mutual fund managers and will support demand for small-cap stocks.

Our 2009 Q4 commentary concluded with a promise to "make every effort in 2010 to keep the demons of regression to the mean at bay." With that accomplishment now behind us, and after such a successful launch of our SMid-Cap product, we move ahead into 2011 with the same vow.

Launching the SMid was done after much soul searching, as we wanted to make sure we were ready and up to the challenge. We are very excited to have another vehicle in which to deploy compelling investment opportunities. We are proud of our 15-year small-cap record and are committed to making our SMid-cap product as successful over the long haul as well. We have a great deal at stake even beyond professional pride, so we will spur our donkeys on, sure that being prepared for an uneven investment landscape will eventually pay off.