First Quarter 2011 Portfolio Commentary

A Quarter with Both Brains and Beauty

By Mariko Gordon, CFA
Founder, CEO & CIO

Small-cap composite

2011 is off to a good start for the Daruma Small-cap composite, which clocked in at 12.85% versus 7.94% for the Russell 2000, for a relative gain of 491 basis points. In all, it was an elegant quarter. The entire portfolio rose to the occasion, with strong stock performance in what were less than stellar sectors for the market. Our bias towards quality served us well, and we had one takeout and one restructuring that boosted results. Growth was rewarded in this market, and the thoroughbreds in the portfolio did well at the track.

While we beat the Index in all three months, most of our gains came in January (126 basis points) and in March, when we picked up another 285 basis points of relative performance.

Small-cap sector scorecard

Consumer Discretionary was a notable laggard for the Index, with returns up only 3.4% for the quarter, but our consumer stocks (overweight relative to the benchmark at 21.5% versus 14.4%) returned 16.5% percent, in part due to a 50% move in Shutterfly (online photo products & services) and a 30% move in lululemon (yoga-inspired athletic apparel). We've held Shutterfly since September of 2007 and lululemon since June of 2009, and have been taking profits along the way.

"It would have been very difficult to outperform the index in 1Q 11 if not overweight Energy" according to small-cap pundit Jim Furey. Despite our energy weight being half that of the Index we managed to do that very feat. Advantage Oil and Gas was up over 31.9% versus 20.7% for the energy sector, as management's plan to unlock value by separating its oil assets from its prime gas assets in the Montney shale was heralded by the Street. As a result, our Energy contribution lag (39 basis points) was much smaller than it might otherwise have been, given our underweight.

The only sector in which we lagged was Technology, where we roughly broke even, while the sector was up over 12% for the Index. Our underperformance had less to do with big stock specific blow ups than with having no exposure in certain industries that drove the benchmark.

Small-cap stock specific highlights

We had two stocks that contributed over 100 basis points each - Shutterfly (164 basis points) and Medicaid provider AMERIGROUP (138 basis points) - while our most notable loser MGIC (private mortgage insurer), detracted a mere 45 basis points. The net contribution of our best three minus

our worst three performers was 264 basis points. Ex the outliers, the rest of the portfolio handily beat the benchmark by over 225 basis points, at 10.2% versus 7.9%. This is an important measure of healthy performance for us - we want performance to be driven by the entire portfolio, not just one or two stocks.

SMid-cap composite

After a great start last year, where we were up 17.82% versus 10.77% for the Russell 2500 since we launched on May 1, we took a breather in the first quarter of 2011. The Daruma SMid-cap composite was up 8.06% versus 8.70% for the Russell 2500, for a lag of 64 basis points. The Russell 2500 was the best performing size segment among the Russell Indices. We had a couple of great performers, but overall the rest of the portfolio did not have the relative lift we like to see. We want every stock in the portfolio to earn its keep, after all.

We lagged slightly in January (1.17% vs. 1.34%) and lagged in February (3.43% vs. 4.88%) but recovered nicely in March (3.27% vs. 2.27%).

SMid-cap stock specific highlights

Hands down our Health Care names were the stars of the quarter, thanks to senior research analyst Mark Miller. Our Health Care stocks returned 24.2% versus 9.4% for the Russell, and because we were also overweight relative to the Index (19.3% vs. 10.5%), this combined to give us a very healthy slug of performance. Star performers were Valeant Pharmaceuticals (markets dermatology, neurology & other drugs), up a whopping 76%, and AMERIGROUP (Medicaid managed care), up 46%.

Good news was also to be found in the Consumer Discretionary sector, where our stocks returned 9.5% versus 6.0% for the benchmark. We had a management led buy-out offer in discount retailer 99 Cents Only Stores, which caused mixed feelings. On the one hand we were happy to have a stock rise 23% in the quarter, on the other we were disappointed to give up what we felt was more upside over the long term. We had great returns in home furnishings retailer Williams-Sonoma (+22%), fine art auction house Sotheby's (+17%) and leading car and equipment rental company Hertz (14%).

Energy and Technology were the sectors that drove the Index, up 21% and 11% respectively. I am sorry to say that while our returns were positive, we were left in the dust in those sectors. E&P company QEP Resources (+11%) was spun out on July 1, 2010, from Utah-based utility Questar. It remains underfollowed and undervalued, despite great growth prospects and a conservative balance sheet and management. Oil-well equipment company Cameron International was up 15%. This was clearly not enough oomph in a red hot sector. As to our Technology names, we took a 42 basis point hit in semiconductor supplier PMC-Sierra, and Rovi (electronic programming guides) cost us another 39 basis points. We continue to hold both positions, as we expect these setbacks to be temporary.

The "It" girls: growth and quality

Growth and quality were the "It" girls for the quarter. What with low yields and fears of inflation, the market continued to clamor for growth. But while growth has been rewarded, quality was equally sought after. It's as if the "It" girls had to have brains as well as beauty.

Thus stocks with a price over $20 were up 9.8% in the Russell 2000 and 9.7% in the Russell 2500, versus a mere 4.0% and 3.6% respectively for those under $5. Stocks whose market caps are over $1 billion were up 9.4% in the R2000 and 9.3% in the R2500, whereas those under $250 million were up only 4.2% for R2000 and 4.1% for R2500. Companies with higher ROIC, ROA and ROE also outperformed those with low returns, but most of all, the fastest growing companies were what the market hungered for. Those with over 20% long-term EPS growth were up 10.6% in the R2000 and 11.6% in the R2500 versus those growing at less than 10%, which were up 5.1%, and 6.2% respectively (Source: Merrill Lynch).

Note that though the quality bias held true for the months of January and February, that trend reversed in March, though not enough to offset the influence of quality for the quarter. It's possible that as fund flows into actively managed small-cap mutual funds tapered off toward the end of the quarter, flows into ETFs accelerated. Flows to active managers get invested in the higher quality and larger names in the Index, while flows to ETFs lift the low quality flotsam and jetsam.

Small versus large

This reversal also held true for small- versus large-cap outperformance. Small has beaten large in seven of the last eight quarters, but in the month of March large took the lead. Small-cap valuations are not to be found in the bargain basement. Relative to large caps, small caps are at a 30-year high in terms of relative forward p/e, and small-cap outperformance coming out of this recession and market

meltdown has been exceptional.

If you look at the current rebound in small caps, the move looks too good to be true. However, Jim Furey of Furey Research makes an interesting point. If you graph the rebound from the prior peak relative to other recoveries, this small-cap rally appears to be in line. If small-cap earnings growth rates continue to exceed those of large, small caps can continue to extend their run.

Exploiting laziness and emotion

At Daruma we continue to sell as valuations get extended. We have a deep understanding of the cash flow and earnings power of some of the powerful business models we hold in the portfolio, but we do not want to lose sight of our sell discipline. In this kind of market, the luxury of our long-term point of view means that we are exploiting laziness and emotion. We are finding opportunities with companies whose businesses are improving but are ignored by Street, either because it requires work to ferret out the progress or because it's easier to react to headlines than to actually parse the news.

We know that the facts will eventually win out. In our quest for finding reasonable valuation, I promise you that we are not scraping the bottom of the barrel of quality and that we are biding our time. It pays to be patient and opportunistic.

It was an interesting market this quarter, buffeted by revolution, natural disasters and nasty political catfights. Much of the Russell's returns got booked in the last 15 days of the quarter as the small-cap cycle relentlessly plows on. Over the past two years small caps are up more than 100%. This magical double in two years has only happened twice since 1947; +142% ending in December 1976 and +116% ending in December 1968 (Source: Furey Research). Being a student of market history I know that one was the first leg up from a mother of a bear market in 1974, while the other represents the culmination of the go-go growth years of gunslinger fame, which ended in ignominy for many. We'll see whether this small-cap cycle will go gently into that good night.

Having said that, we are blessed to run a concentrated portfolio, where we expect to put up a good fight, cycle or no cycle, by having every stock earn its keep. We will stick to our prime directive.

Small-Cap Returns Going Into and Coming Out of Troughs

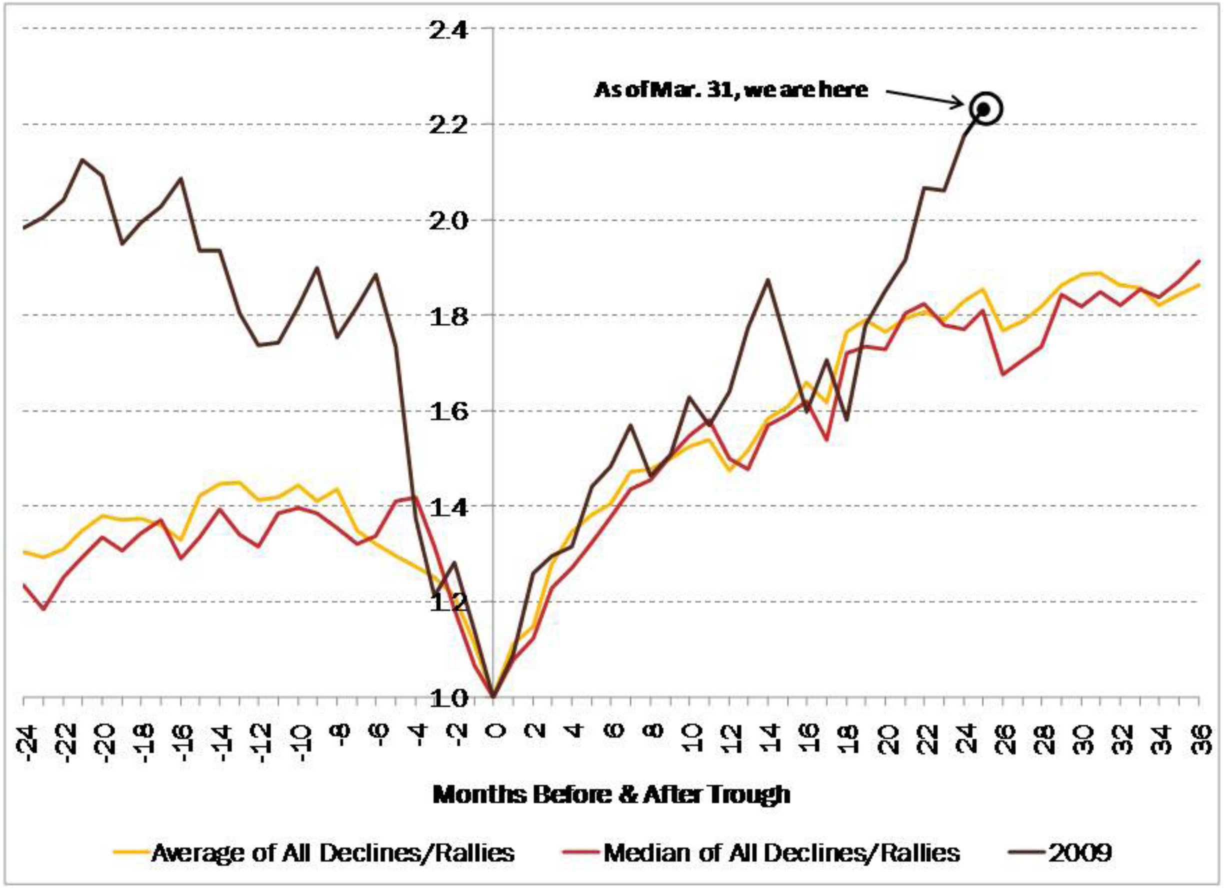

Figure 1:
Small-cap returns 25 months out of the Feb-09 trough, have been significantly better than the historical average, but one needs to consider that the decline going into the Feb-09 trough was also much greater than average (as of 03/31/11).

Source: Furey Research Partners

First Quarter 2011 Portfolio Commentary

Small-Cap Returns from Prior Peak

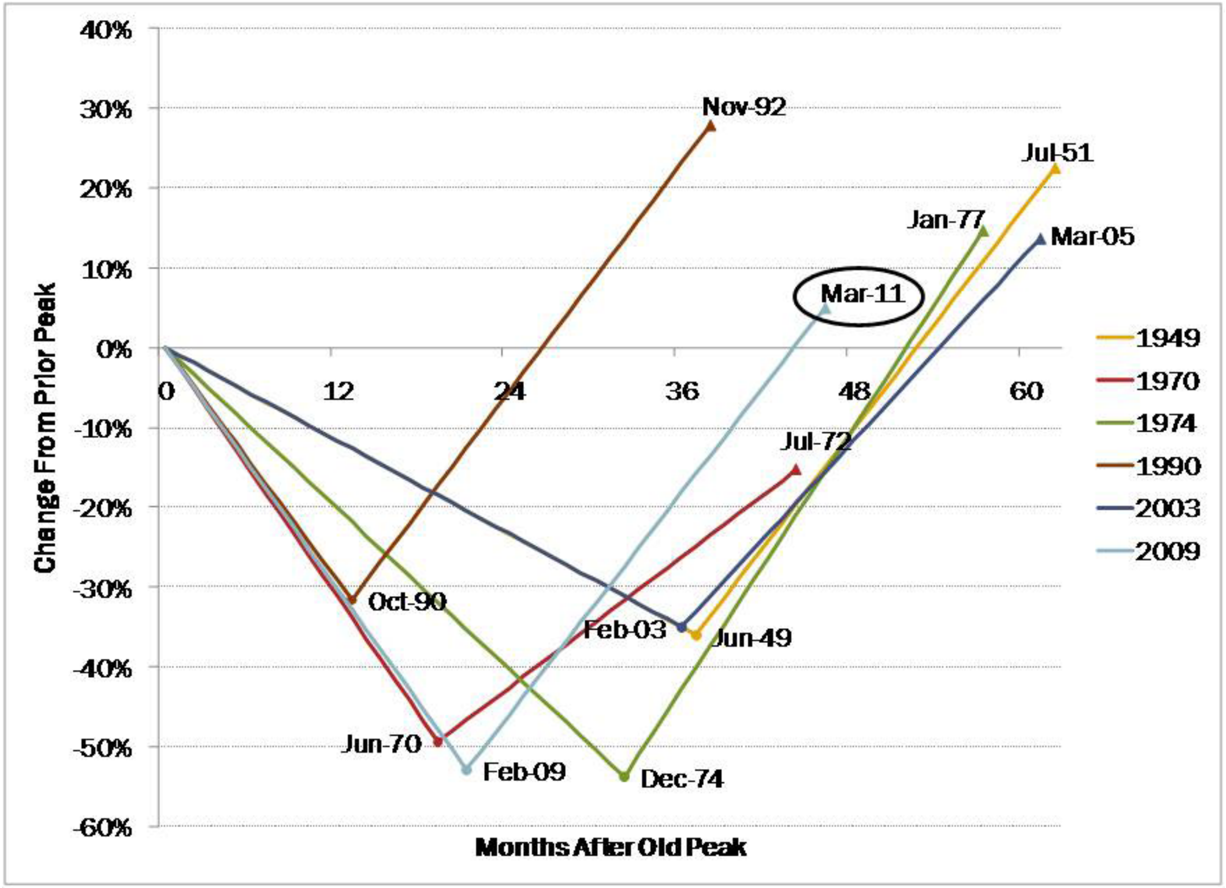

Figure 2:
Using a different perspective (change from prior peak), small-cap returns appear in-line through 1Q11 (as of 03/31/11).

Source: Furey Research Partners