2012: Out with the Old, In with the New

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The good news about the fourth quarter is that the market was up. The bad was that we trailed by 300 basis points, clocking in at 11.5% versus 14.5% for the Russell 2500.

This resulted in an unacceptable return for 2011 of -16.7% versus -2.5% for the benchmark, or a lag of 14.2%. The year's results eroded the great start we had after launching the SMid last spring, when we'd built a 700 basis point lead in a mere seven months. Since inception we are now down 1.1% versus the Russell 2500's +4.7%, trailing by 580 basis points.

For the fourth quarter we had five stocks that contributed over 100 basis points each, but two big losers (Internet photo retailer Shutterfly and interactive program guide maker Rovi) cost us 180 and 130 basis points respectively. Both companies lowered guidance and got hit hard as a result. In Shutterfly's case, it was due to an intensely promotional environment and in Rovi's case, it was due to a customer sunsetting a legacy product unexpectedly. Our next biggest loser, RFMD, by contrast, cost us 66 basis points.

This meant that the lift our big winners gave us was offset by the drag of our losers, so we got little help from our outliers. Although 55% of our portfolio was up more than the benchmark in the quarter, that wasn't enough to beat the Index, as the portfolio net of the impact of outliers was up only 11.9%.

We started the quarter with five straight weeks of up relative performance (the longest streak in the year), leading us to book a good October, up 16.57% versus 14.66% for the benchmark. November was the nadir, where we absorbed most of the damage from Shutterfly and Rovi, causing us to be down -4.62% in a market that was flat at -0.35%. We eked out a small gain in December at 24 basis points versus 23 for the Russell 2500.

Looking at the portfolio as a whole, sectors that contributed positively in our portfolio relative to the benchmark were Health Care (+1.19) and Consumer Discretionary (+.79). Underperforming sectors of note on a relative contribution basis were: Technology (-1.60; we were overweight and our stock returns (especially, though not exclusively, Rovi) were lower than the Index sector), Energy (-1.07; we were underweight and had a lower comparative return; Energy was the strongest performer in the benchmark, up 23.73%) and Financial Services (-.88; stock selection was good, which meant we held on to the right financial stocks when we lowered our exposure to more normal levels for Daruma, but our underweight now hurt us).

There is a laundry list of factors that contributed to this dismal performance, most of which are self-inflicted. The market was highly correlated and volatile. Though the year ended with the benchmark only down 2.5%, there was a lot of damage done to individual stocks in the course of these violent swings. Defensive stocks were the clear winners, where we don't have much exposure. Stocks moved sharply in one direction or another, driven by macro factors, starting with Washington's inability to come to terms with the debt ceiling, S&P's downgrade and ending with the continued financial crisis in Europe. Mid-year, investors started worrying about the slowdown in the US economy, taking down economically sensitive stocks. The European crisis hit the market hard in the late summer, especially financials. By year-end, investors were feeling better about the US economy, but were nervously watching China for signs of an imminent meltdown. In this skittish environment, companies that guided down were punished severely, and it seemed that good news was greeted with a yawn. Energy was a big mover in the fourth quarter, and the financials had a dead cat bounce as fears of 2008 redux faded.

Of the things we control, here's where, with the benefit of hindsight, we zigged when we should have zagged:

1. We owned too many companies whose stock prices would be more influenced by macro factors than company-specific events. We learned this lesson in Small-Cap in 2002, and we have no excuse for making the same mistake in SMid-Cap in 2011. The result of some companies, industries and sectors are more dependent on the macro environment than the changes they are making internally. In some instances we round-tripped some stocks that had done well for us in 2010 when investors were feeling better about the economy. We had more economic sensitivity within the portfolio than is typical for us, especially to residential housing.

2. We had an equal weight in Financial Services relative to the Index going into the European debacle. This is the one true divergence from our behavior running small-cap money in 17 years – we have been chronically underweight in financials precisely because they are by definition highly levered, have financial results that are largely driven by macro factors such as the yield curve, and have opaque financials. In the past we've done well buying plain vanilla banks and thrifts during a time of industry consolidation. While the financials we bought in SMid had Daruma-like characteristics by either having new management restructuring the balance sheet or an operating overhaul, the macro swamped the stock-specific. We were seduced by the valuation case and lived to regret it. One stock in particular, private mortgage insurer MGIC (which we also owned in the Small-Cap portfolio) cost us 344 basis points. While we've taken such hits before, we do so rarely, as we prefer to more successfully contain our losers.

3. We also did a lousy job in Technology. Being overweight a sector (20% versus 12%) and having subpar returns (-29.83% versus -8.95%) is not the path to riches. We had too many losers, with four stocks costing us over 100 basis points. One or two mistakes is an occupational hazard – four means we need to revisit our process. We concluded that we are in an era of tectonic changes in the technology landscape, and it is critical to look up from the weeds and understand the implications of colossal shifts in where cap ex dollars are going to be spent and of the emergence of disruptive business models and technologies. We do a great job drilling down into company-specific changes, but these changes can become swamped very quickly by larger forces, not just macro, but those tectonic technological changes. We can, and have, added value in the Technology sector historically, and we plan on doing so going forward. We are tuning our process so that we can see the forest for the trees, by asking a broader range of questions and spending more time on the entire technology ecosystem and demand drivers. In short, we need to have a better balance in our research between laser beam and floodlight analysis.

In sum, for the year the damage was wrought largely through our stock picking, where we had only two stocks (managed Medicaid provider Amerigroup and drug maker Valeant Pharmaceuticals) contribute over 100 basis points while a whopping 11 stocks each cost us over 100 basis points. What's disappointing also is that we sold six after concluding that we were wrong about our investment thesis. As you know, we have a 90-day sell rule in which we either sell or buy more of a stock that's down 15% or more relative, and during big market downdrafts we are eager to buy merchandise on sale. It was disappointing to be net sellers of positions that weren't performing, because we were wrong.

Largely driven by the stock selection, the biggest sector detractors on a relative basis for the year were Financial Services (567 basis points), Technology (524 basis points) and, unusual for a sector we normally excel in, Consumer Discretionary (366 basis points). Best relative sectors were Health Care, contributing 368 basis points and Materials and Processing at 110 basis points.

Make no mistake, we are extremely unhappy about having given up such a generous lead in 2010 during the course of 2011. While some tell us we are being very hard on ourselves as it was a tough market for many, and that in a highly correlated, macro-driven market stock pickers will struggle, we do feel that a lot of our underperformance was self-inflicted, and we are taking corrective measures.

We have an extremely competitive team, with a lot of professional pride, and we hate to let our clients down. We have dug ourselves out of similar performance holes before, and are bringing everything we have to bear to ensure that we do so again.

In contrast, on the business front 2011 was a year of great progress for Daruma. After a four-year hiatus we once again have a Chief Operating Officer at the helm to run the non-investment side of the business, in the very capable person of David Gerber, bringing me tremendous peace of mind and freeing me to focus on managing our portfolios. The transition is now complete, and I could not be happier.

Veronica Stork, our Chief Compliance Officer, joined us in late October and is a fantastic addition to our team, given her legal training and extensive industry experience. Her bio can be found in the Appendix. The operations team has been busy automating and streamlining processes, giving the investment team valuable and timely reporting.

It is now up to the investment team to diligently sift through new ideas and put continual pressure on our portfolio holdings to earn their keep. A healthy new idea flow is the best medicine for what ails this portfolio. We built a 17-year track record one stock at a time, and we will rebuild performance — as we always have in the past when we've lagged — one stock at a time as well.