It Ain't Over 'Til the Fat Lady Sings

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This year began with a bang and ended not in a whimper but a howl of frustration.

In the fourth quarter we were up 10.7% versus the Russell 2000's 15.5%, lagging by 4.8%. This meant that we lagged the Russell 2000 for the year, down 10.3% versus -4.2% for the Index. This was the sixth time in 17 years that we underperformed for the year (this time by 610 basis points), but only the third time that we had a down year compared to six for the benchmark.

After a tough third quarter we were off to the races in October, up 17.33% versus 15.14% for the Index, boosted by good performance in managed Medicaid company Amerigroup and online education provider K12. As the market stalled out in November, down 0.36%, we were hit hard by three stocks: Internet photo products retailer Shutterfly, interactive program guide provider Rovi and, in an unexpected reversal, online education provider K12, all of which delivered news that spooked investors.

These were largely responsible for our being down 5.10%, or 474 basis points on a relative basis. The month of December was much less dramatic, with our portfolio being down 61 basis points while the benchmark was up 66, adding another 127 basis points to the gap.

This was not the desired finale to a year that had started out so promisingly, with our beating the Index 10.8% to 6.2% at the end of June for a lead of 460 basis points. At one point during the year we were over 700 basis points ahead of the Index. This is a humbling business, indeed.

There were many things that contributed to our underperformance, some of which we controlled, and others which we did not. It was a tough year for active managers to beat the benchmark, as macro factors drove markets to such an extent that all stocks seemed to move in a stampede dictated by the euro crisis headline du jour. For the year, the clear winners were defensive stocks and those with juicy dividends, not the sort of merchandise we traffic in.

We also did not have a great stock-picking year. Our new buys did not contribute much in the way of performance, and some of our warhorses seemed ready for the glue factory as the year progressed. These markets have been particularly unforgiving of any slowdowns in growing companies; there were many times when good news was greeted with a yawn but the slightest whiff of bad news was cause for a riot. The unsteady macro environment made demand and visibility unpredictable for companies across the board, and it was hard to sort out the signal from the noise in terms of what drove fundamentals.

Our best sectors were Health Care (up 20.84% versus 1.98% for the benchmark, generating a contribution of 291 versus 20 basis points) and Producer Durables (up 6.52% versus -6.12% for the Russell 2000, generating a contribution of 111 basis points versus a loss of 68 basis points).

Technology cost us dearly in 2011. Not only were we overweight the sector but did a poor job with our stock picks, which were down 24.28% versus -8.44%, costing us 606 basis points versus 117 in the benchmark, for a gap of 489 basis points. We are working hard to remove the process blinders that have contributed to our underperformance in this sector. There are tectonic upheavals happening in the landscape of Technology, and we need to make sure that we are not so in the weeds that we miss the big picture.

Consumer Discretionary, historically the sector in which we deliver consistent outperformance, also struggled, with our stocks returning -13.32% versus -7.30% for the Index, costing us 323 in contribution versus 110 for the Russell 2000, or a gap of 213 basis points.

Our single worst stock of the year was private mortgage insurer MGIC, which cost us 354 basis points. Investors got nervous in the early summer when the consumer hunkered down and housing slowed down, as it might mean a need to goose reserves. With the US sovereign debt downgrade and the European crisis hitting late summer, the stock fell fast and hard, as did many financials. This was a reminder that we've been significantly underweight financials for years for a reason — the financial leverage inherent in their business models means that when the macro sneezes, they catch the flu. We've done well in the past with plain vanilla banks and thrifts, though it can be difficult to make a case for 50% upside in those stocks.

The portfolio construction process and the characteristics of the portfolio itself were very typical in 2011, though they did not deliver the desired typical results.

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.

Our Chief Compliance Officer Veronica Stork, who joined us in late October, is a tremendous 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.

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Past performance is not a guarantee of future results. Many factors affect performance, including changes in market conditions and interest rates, as well as other economic, political and financial developments. You should not assume that investment decisions we make in the future will be profitable or will equal the investment performance of the past.

The portfolio is actively managed, so holdings, sector weightings and other portfolio characteristics may have changed since the date shown. They should not be considered recommendations to buy or sell any security or of a particular allocation. You should not presume that any holding or allocation shown has been or will be profitable.

The appropriate comparison benchmark for the Small-Cap Equity strategy is the Russell 2000®. The Russell 2000® includes approximately 2000 of the smallest U.S. common stocks based on a combination of their market cap and current membership in the Russell 3000®. The Russell 2000® Value Index includes those Russell 2000® Index companies with lower price-to-book ratios and lower forecasted growth values, while the Russell 2000® Growth Index includes those with higher-price-to-value ratios and higher forecasted growth values. The Small-Cap Equity strategy is a concentrated strategy that is not managed to a benchmark, so there are material differences in characteristics, such as the number of holdings and sector and industry weightings. In addition, benchmark performance does not include any fees or expenses. Because of these differences, benchmarks should not be considered a completely accurate comparison.

Several charts are included in the book to demonstrate certain information or conclusions. You should not make any investment decision relying only on these charts.

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