Movin’ on Up

By Mariko O. Gordon, CFA

We got off to a good start this quarter, ahead of the index by 156 basis points, with our SMid-Cap composite up 14.55% versus 12.99% for the Russell 2500. It was a welcome start to the new year, and the seventh best first quarter for the index since its inception in 1979. We were very pleased to have done so well, given that it can be hard for us to keep up in strong markets.

For the index, January was the strongest month in the quarter, up 6.65%, with each month getting progressively weaker (3.71% in February and 2.15% in March). By contrast, we more or less kept up in January at 6.35%, knocked the socks off the market in February, when we were up 6.44%, and then retreated a bit in March, when we were up only 1.2%.

Our best sector contributors to performance relative to the benchmark were health care (140 basis points), technology (91 basis points), and consumer discretionary (+90 basis points). While returns lagged slightly, we were overweight those groups, which made their contribution more significant. As you know, our sector exposures are built stock by stock, and as a result our sector exposures differ materially from the benchmark.

Our top three winners, Assured Guaranty (financial guarantor), Armstrong World (flooring & ceiling products) and Shutterfly (online photo products & services) each contributed over 100 basis points to performance, for a total of 351 basis points, whereas our top three losers Urban Outfitters (multi-brand specialty retailer), International Game Technology (slot machine maker) and Williams-Sonoma (home furnishing retailer) detracted only 95 basis points. This gave us a healthy net contribution from our outliers of 256 basis points. In all we had four stocks contribute 100 basis points or more to performance and none that detracted more than 40 basis points. Details on our winners and losers can be found in the performance section.

The rest of the portfolio contributed 11.99%, lagging the benchmark by 100 basis points. So while we are pleased that we beat the market in such a strong tape, we won’t take a victory lap until we have a better combination of drivers to our results: our goal is to book solid winners, minimize losers, and have the rest of the portfolio in aggregate outperform the benchmark.

We made a number of changes to the portfolio this quarter, selling Urban Outfitters, Williams-Sonoma and International Game Technology. We initiated new positions in Brunswick (maker of marine engines, boats & recreational products), Riverbed Technologies (WAN optimization vendor) and added two positions we already owned in our small-cap portfolio, United Stationers (office products wholesaler) and Healthsouth (inpatient rehabilitation services). Write-ups on these purchases and sales can be found in the portfolio detail section.

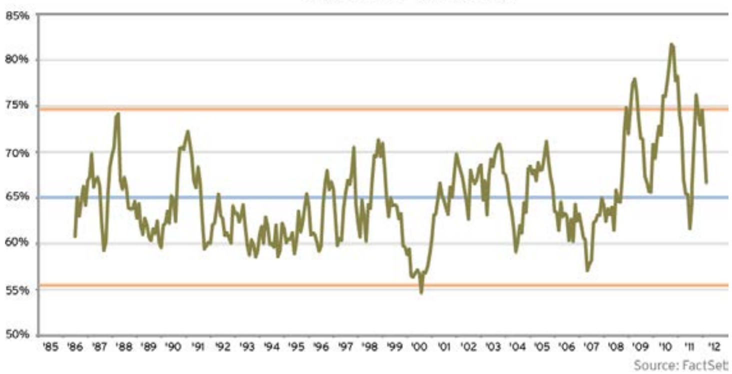
19 positions were up more than the Russell 2500, with Sotheby’s (fine art auction house) leading the pack, up 38.2%, and Shutterfly hard on its heels, up 37.6%. Sotheby’s went up as macro fears of a further global financial meltdown waned. Landing Edvard Munch’s iconic *The Scream*, which is expected to fetch close to $70 million at auction didn’t hurt either. Shutterfly went up as fourth quarter results showed that the company maintained its financial discipline in the face of a highly promotional holiday season, and as it emerged as the stalking horse bidder of Kodak’s photo sharing assets. In the past Shutterfly has done a good job monetizing acquired customers.

What held true for the market as a whole also held true for our portfolio: those stocks that were down the most last year rebounded sharply in the quarter. As signs that the US economy was in better shape, and that Europe at least slowed its unraveling, stocks that were exposed to US housing, Europe, and that were more broadly economically sensitive, (e.g. semiconductor stocks) performed well.

The index in this quarter was powered by the technology and consumer discretionary sectors. On a stock level, lower quality led the way — the larger companies (market caps over $1 billion) were the laggards (up only 12.7% versus 17% for the smallest quintile), the companies losing money were up a strong 18.6%, and low ROE and low priced stocks also ripped, up 18%. However, in March there was a reversal in market sentiment, as high beta stocks faded, and value beat growth. Overall though, the change in investor psychology in March was not enough to undo the momentum that the more speculative and faster growing stocks had in the first two months of the year.

Volatility has declined sharply with the VIX at 15.5 and market breadth has widened considerably. As you can see in Figure 1, the percentage of Russell 2500 stocks moving in the same direction continues to decline, and as correlations among stocks loosen, stock picking becomes easier (in theory at least).

Figure 1. **% of R2500 Stocks Moving in Same Direction (6-Mo MA)**
June 1986 - March 2012



The view from Main Street is that earnings should hold up well this quarter, though the Street is fretting about forward guidance. Collectively, the Small- and SMid-Cap indices seem fairly priced, but balance sheets are strong, and we expect to see a continued pick up in M&A activity. There's no question that many companies radically reduced their cost structure during the financial crisis, and the operating leverage on any uptick to sales will be a powerful driver to earnings. This will make current valuation levels look even more reasonable. However, earnings growth will be hard to maintain without better top line growth.

After this powerful six-month rally though, insiders are negative, the impact of gas prices on consumer psychology is a question mark, Europe could still surprise negatively, and every variant of Quantitative Easing results in less juice to the market.

While we got good performance this quarter from our technology stocks, we want to be sure that we own those stocks that are most "Daruma-like" while also being long-term beneficiaries of the massive changes that are occurring in the tech landscape today, which reminds us of the late 90s. Technology stocks are still cheap on both an absolute and relative basis, have great balance sheets in aggregate and have earnings estimates for 2012 that may be too low. Our health care stocks, which performed exceedingly well last year, took a breather this quarter. There remains a lot of uncertainty in the group as the Supreme Court evaluates the constitutionality of the health care reform act. (We expected weakness in some of our health care winners as we approached Supreme Court review, so we preemptively pruned our exposure beginning late in the fourth quarter.) We are comfortable with the full range of possible outcomes and believe the worst is priced into our holdings.

Financials have long been under owned and unloved, and should the rally in financials catch on fire we may find it difficult to keep up, given their large weight in the benchmark. This happens to us from time to time. As we learned last year, financials has not been an area where we've historically added value, given their macro sensitivity, innate leverage, opacity of their financials, and difficulty in finding company specific drivers to positive change in the rate of change in fundamentals. We'll stick to our knitting, but this may mean staying home instead of going to a wild and exciting party in the coming months.

We have otherwise been building our pipeline of new ideas, waiting for the right entry points, and we expect to take advantage of any dislocations during earnings season.