Happily Keepin' up with the Joneses

By Mariko O. Gordon, CFA

Our Small-Cap composite nosed out a 39 basis point gain versus the Russell 2000, up 12.83% versus 12.44% for the quarter. Not that we are complaining. When the markets go on a tear we are often left in the dust, and so are delighted to find ourselves in a photo finish for this first quarter's race.

Our relative performance was consistent from month to month, with February being the highlight of the quarter: January clocked in at 6.93% versus 7.07%; February at 3.11% versus 2.39% and March at 2.33% versus 2.56%.

The net of our top winners and losers made the difference this quarter, contributing 229 basis points. Our top three winners, Lumber Liquidators (DIY hardwood flooring), Shutterfly (online photo products and services) and Plexus (electronics manufacturer), generated a total of 322 basis points, while our top three losers, Advantage Oil and Gas (explores and develops oil and gas), Allscripts (IT solutions for health care) and Vera Bradley (handbags and accessories) detracted 93 basis points.

However, the rest of the portfolio lagged the index, contributing 10.5%. As you know, we prefer to have every stock earn its keep by having the non-outliers outperform in aggregate, and then goose those returns with a healthy boost from our net outliers.

Not investing in REITs (we consider them a separate asset class) also hurt us, as they contributed 104 basis points to the Russell. Financials, while up 9.5%, (trailing the benchmark by 206 basis points) are such a large weight (23.6% of the Russell 2000) that they contributed 269 basis points to the benchmark. We remain underweight as usual at 7.1%; our two financials Wright Express (payment processor) and Validus Holdings (reinsurance provider) contributed 65 basis points.

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.

19 positions were up more than the Russell 2000 in the quarter, with Lumber Liquidators leading the pack, up 42% as investor sentiment warmed up towards the housing sector, and as Lumber starts to get credit for its operational overhaul.

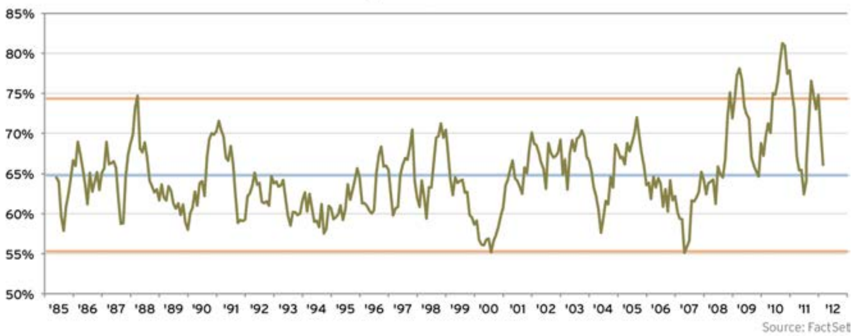
Ironically, the same technology stocks that contributed to last year's underperformance came roaring back in the first quarter and generated an extra 343 basis points above the benchmark's tech contribution. Our best performers were Ciena (telecom equipment supplier) and Rovi (electronic programming guides) up 34% and 32% respectively.

This quarter has been one of the top ten (#9) best first quarters for the Russell 2000 since inception. The average first quarter return is 4.7%.[1] Led by lower quality and more cyclical names, the first quarter leaders continued a trend begun at the start of last year's fourth quarter. The smaller market cap, highest beta, lowest ROE and lowest priced stocks performed best. Defensive groups such as consumer staples and utilities lagged meaningfully.

[1] BofA Merrill Lynch Small-Cap Research; Russell Investment Group

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 2000 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 R2000 Stocks Moving in Same Direction (6-Mo MA)
May 1985 - 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 Russell 2000 seems 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.

We did little with the portfolio, except for adds and trims. This is part of a normal ebb and flow for us, particularly after volatile market periods. Apparently we are not alone. Lori Calvasina, the small-cap strategist at Credit Suisse notes that small-cap turnover is at its lowest levels since 2002.[2] In her March survey of small-cap managers there was no clear reason for this.

For us, we decided to stay put while we conduct a soup to nuts review of our technology stocks. While we got good performance this quarter from our holdings, we want to be sure that we own those tech 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. It's hard for us to find "Daruma stocks" in the bank and thrift sectors in particular, as they typically lack the kinds of positive rates of change that our investment case needs to hinge on.

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.

[2] *Peering into Small Cap Portfolios* 16 February 2012

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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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