# Close Only Counts in Horseshoes and Hand Grenades

By Mariko O. Gordon, CFA

**We had a respectable fourth quarter, up 3.86% versus 3.10% for the Russell 2500, for a relative gain of 76 basis points. Despite this being our second quarter in a row of out-performance and despite outperforming in three out of four quarters this year, we still lag for the year. In 2012 we were up 14.20% versus 17.88% for the Russell, trailing by 368 basis points.**

## Fourth quarter scorecard

The net of our top three and bottom three stocks contributed 60 basis points, with the rest of the portfolio kicking in another 326 basis points. This made for a solid report card, as we always like to have the rest of the portfolio beat the market, and have the net of our outliers act as a kicker.

Our top three stocks — marine engines, boats & recreational products maker Brunswick (+101 bps), used car retailer CarMax (+93 bps), and hard disk drive manufacturer Western Digital (+56 bps) — generated 250 basis points in total, whereas our bottom three stocks — WAN optimization vendor Riverbed (-85 bps), national department store J.C. Penney (-61 bps) and inpatient rehabilitation services provider HealthSouth (-44 bps) — detracted 190 basis points.

Over 58% of our holdings in the quarter beat the Index return. Our best performing sectors on a returns basis were Materials and Processing and Financial Services. The only two sectors where we underperformed on a returns basis were Energy and Producer Durables. We had no exposure to Utilities (which helped contribution by 11 basis points) or Consumer Staples (which hurt contribution by 12 basis points).

## 2012 scorecard

We are not happy to have lagged the Russell 2500 again this year. Over our 17-year track record for Small-Cap we lagged two years in a row only once, back in 2002 and 2003, seven and eight years after inception. It is a disappointment that after a great start in 2010, when we were up 705 basis points over the benchmark in seven months, we trailed in years two and three after launch.

As noted at the start of this commentary, the year has had its fits and starts, with three solid quarters of outperformance out of four. We have been working our way back from our tough April and May which together cost us 654 basis points. Especially in May, when the Russell 2500 was down close to 7%, the portfolio behaved as though it had a millstone around its neck relative to the market. In May we had eight stocks that cost us over 50 basis points each, and only three stocks that were up, causing us to trail by 420 basis points that month. Most of those stocks have recovered since then, but we have not yet completely closed the gap.

For the year we had 12 stocks contribute 100 basis points or more each, with four positions detracting by that amount. Our best performing stocks were Medicaid managed care provider AMERIGROUP (+168 bps), Medicaid enrollment & outreach provider MAXIMUS (+161 bps) and internet domain name registration vendor VeriSign (+145 bps). In total they generated 474 basis points in 2012. Our bottom three performing stocks were J.C. Penney (-141 bps), Riverbed Technology (-116 bps), and electronic programming guides maker Rovi (-114 bps). Collectively they cost us 371 bps for 2012. The net of our outliers was a positive contribution of 102 bps. The rest of our portfolio generated 13.18%, not enough to beat the Russell 2500's 17.88%.

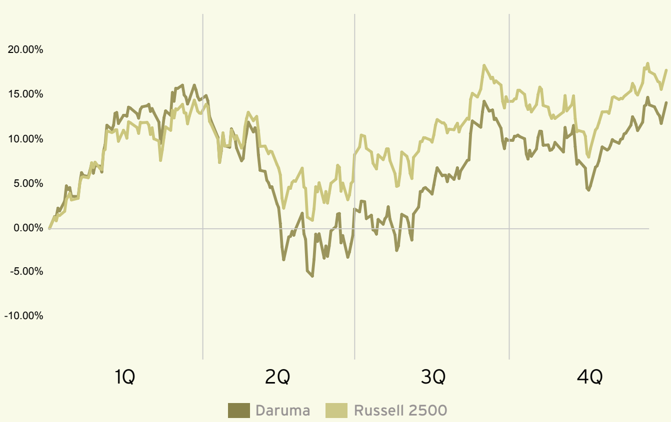
**Our Best and Worst Stocks**

| 4Q | | | 2012 | | |
|---|---|---|---|---|---|
| Best | Position Size | Contribution | Best | Position Size | Contribution |
| Brunswick Corp. | 4.2% | 1.0% | AMERIGROUP | 0.0% | 1.7% |
| CarMax Inc. | 3.1% | 0.9% | MAXIMUS Inc. | 3.1% | 1.6% |
| Western Digital | 3.2% | 0.6% | VeriSign Inc. | 0.0% | 1.4% |
| | Total | **2.5%** | | Total | **4.7%** |
| Worst | | | Worst | | |
| Riverbed | 0.0% | -0.9% | J.C. Penney | 2.3% | -1.4% |
| J.C. Penney | 2.3% | -0.6% | Riverbed | 0.0% | -1.2% |
| HealthSouth Corp. | 2.9% | -0.4% | Rovi | 2.3% | -1.1% |
| | Total | **-1.9%** | | Total | **-3.7%** |
| Best minus Worst | | 0.6% | Best minus Worst | | 1.0% |
| Rest of Portfolio | | 3.3% | Rest of Portfolio | | 13.2% |
| Daruma SMid-Cap | | 3.9% | Daruma SMid-Cap | | 14.2% |
| Russell 2500 | | 3.1% | Russell 2500 | | 17.9% |
| Return Difference | | 0.8% | Return Difference | | -3.7% |

## Sectors

For the year on a returns basis, we lagged the benchmark sectors in Technology and Consumer Discretionary. Because we were also overweight these sectors, it meant that we also lagged on a contribution basis as well. Our Consumer Discretionary generated only 230 bps versus the Russell 2500's 351 bps; our Technology stocks detracted by 138 bps compared to the 148 bps generated by Technology for the benchmark. In both cases, stock picking, more than industry exposure, was to blame. We mentioned in our 2011 post mortem the need to reposition our technology stocks, which we have done over the course of the year, and we are comfortable with our exposure.

2012 SMid-Cap Composite Performance Versus the Russell 2500

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The rebound in Financial Services in SMid-Caps proved to be a headwind for us. Our underweight in Financial Services cost us 290 basis points (176 alone from REITs, which we do not own as a matter of policy). Our stock selection in financials, however, was good, as our 30% return was better than the benchmark's 20%. But, because financials were up more than the benchmark for the year, it generated a large performance headwind for us, given the sector's large weight (24.6% at year-end) in the Index versus 3.5% for our portfolio. Not owning any defensive stocks like Utilities or Consumer Staples cost us 107 basis points in relative contribution.

Our best sector contributor was Health Care, which generated 577 basis points for our portfolio versus the benchmark's 243 basis points. We were both overweight and had better returns than the Russell 2500's Health Care sector. Our Health Care returns were driven by AMERIGROUP, dental equipment manufacturer Sirona Dental Systems and dermatological and other drug marketer Valeant Pharmaceuticals.

We added 16 new names to the portfolio and sold 12. This is a bit higher turnover than we anticipate having on average (though well within the expected range), and reflects the changes in our technology exposure referenced above.

## Market perspectives

The market has been climbing a wall of worry, with the Russell 2500 quietly making an all-time high. Somehow that memo got lost in all the noise about the fiscal cliff. Generally, we feel constructive about our SMid-Cap world. Valuations on an absolute and relative basis are by no means stretched, and even arguably undervalued. The usual warning signs (high yield weakness, yield curve, CDS prices on financials, VIX (despite the fiscal cliff induced tick up)) are benign, whereas economic sentiment continues to be negative. Indeed, this is the second year in a row of active small-cap and mid-cap mutual fund outflows. Since March of 2009 we have been in both a bull market and an economic recovery, but investors don't seem to believe it, given the continued flight to fixed income from retail and institutional investors alike.

## Housing and international exposure opportunity

Investors continued to punish stocks with international exposure for the year, though that did reverse after election day, when investors started to worry more about our politicians' ability to wreak havoc upon our own economy rather than about global macro policy. We are beginning to see encouraging signs of recovery abroad, and this could bode well for a number of our stocks with healthy foreign exposure. Foreign markets have recovered nicely, which suggests some optimism for the future from the locals, but U.S. investors aren't yet willing to give credit to U.S. stocks that have material international operations.

We do think the recovery in demand in the U.S. for housing, commercial construction and autos is not only real, but also structural, so that we don't need a strong economy to fuel decent rates of change. All of this is contingent, however, on consumer sentiment holding up in the face of a crisis of confidence in our government. We will be watching closely corporate earnings and sales growth rates this earnings season. Insider selling has been very negative, but fiscal cliff fears have created a distortion in the normal pattern of sales. For this reason we do not feel it is an accurate current gauge of sentiment on Main Street.

We continue to look for those companies that have some control over their destiny, while keeping an eye on the macro tidal charts, lest we be stranded at low tide with an expensive stock. The beauty of a concentrated portfolio is that we need find only a few stocks that have good business models and good management. The tough part is finding those at a price that allows us to make a case for 50% upside. Nevertheless, over the past 17 years we've stuck to our prime directive and attempted to apply our process consistently, all the while continually seeking to "make better mistakes tomorrow."

Economic theories evolve, financial instruments are invented, disruptive technology alters the landscape, and new business practices are quickly adopted across an increasingly interdependent globe. While we may not know what tomorrow's disruptive changes are, we can be certain that there will be disruption, and that we need to be able to recognize the changes and understand their effect on our world of small- and smid-cap investing.

And yet through all this, one constant remains at Daruma: no more than 35 stocks, no less than 25 stocks. In sum, we manage a portfolio where every stock counts, and where we have nowhere to hide. There is no better investment discipline than this, from where I sit.

## Post-mortems and gratitude

As I look back on 2012, doing my annual post mortem on what we did well and what we need to do better, I find myself grateful to be a practitioner of such an exacting craft -- one that requires constant vigilance, demands intellectual growth, fosters curiosity and provides an all-you-can-eat buffet of humble pie, 24 hours a day, 7 days a week. It certainly builds character, if nothing else.

In addition, I am very thankful to be working with such a great team at Daruma. Their enthusiasm and willingness to bring their all to work is an inspiration. It is now almost two years since David Gerber joined Daruma as Chief Operating Officer to allow me to focus on managing our investment team, process, and portfolios. As you can see from the collection of nametags from research conferences and company visits, it's been a busy year for me, and I couldn't be happier to be devoting almost all of my time to research and picking stocks.

And while my efforts may be focused on investing, our entire team, no matter their job function, is acutely aware on whose behalf we toil. The entire firm meets formally monthly, and we also gather informally for a family style lunch every Friday. At these gatherings I often talk about you, our clients, who are the life force of our business. I do this to ensure that no one here thinks of you as just performance numbers on a page. After all, isn't performance what enables your or your constituents' hopes and dreams? If we do a good job for an animal rescue foundation, it means one more Chihuahua gets adopted in Denver, Colorado; for a college endowment it means one more kid gets a scholarship; and for our public pension fund clients it means that one more teacher, firefighter or police officer can retire with peace of mind. Truly, there is no better reward than this.

Thank you for making it possible. ●