# Return of the Jedi

By Mariko O. Gordon, CFA

**The force was with us this quarter, as we had by all measures a good quarter, up 5.66% versus 1.85% for the Russell 2000, for a total of 381 basis points of outperformance. For the year, the Small-Cap composite was up 19.89% versus 16.35% for the benchmark, a relative gain of 354 basis points. We are satisfied with our annual scorecard relative to our peers, as the year has been a tough one for active Small-Cap mutual fund managers, with only 27.9% of them beating the Index in 2012 — the worst showing since 2008, according to Steve DeSanctis of Bank of America Merrill Lynch.**

### The fourth quarter scorecard

The quarter's beat was a high quality one: we were up on a relative basis every month in the quarter, and the portfolio as a whole earned its keep. The net of our top three and bottom three stocks was 109 bps; the remaining positions generated an additional 457 bps, thus beating the Index by a healthy margin as well in their own right. Our top three (marine engines, boats & recreational products maker Brunswick +100 bps, casino operator Pinnacle +80 bps and modular carpet manufacturer Interface +61 bps) contributed 241 basis points in total, while our bottom three (inpatient rehabilitation services provider HealthSouth -45 bps, internet radio provider Pandora -45 bps and global casual footwear maker Crocs -41 bps) detracted a total of 131 basis points. Most pleasing was the lift that came broadly across the portfolio, with 70% of positions held in the quarter beating the Index.

Our stock selection in materials and processing was the standout this quarter, with flooring & ceiling products maker Armstrong, roofing distributor Beacon, Interface (all companies with exposure to U.S. residential and commercial construction) and Schulman (specialty plastics compounder) all beating the Index sector returns. On a returns basis, the only Daruma sector that did not beat the Index was Energy, as both ION Geophysical (oil exploration services) and Advantage Oil & Gas (explores & develops oil and gas) were down more than the Index.

On a contribution basis, Technology exceeded the Russell 2000 by 115 basis points, while Energy detracted an incremental 43 basis points. Again performance was generated broadly across all sectors excluding Energy.

We added four new positions (satellite operator Digital Globe, fashion apparel retailer Francesca's, Beacon and auto dealer software maker Dealertrack) and sold two (Medicaid managed care provider AMERIGROUP and hospital bed & medical products maker Hill-Rom) in the quarter.

### The 2012 scorecard

The composition of performance for the year is more mixed. We outperformed in six out of the 12 months, ending the year with a strong finish.

The net contribution of our best and worst stocks carried the day, with 551 basis points of performance. Our top three stocks generated 851 basis points, with Lumber Liquidators (DIY hardwood flooring) alone contributing 516 bps. Lumber was one of the best performing stocks in the market, up 199% for the year. Medicaid enrollment and outreach provider Maximus (+170 bps) and AMERIGROUP (+165 bps), which was acquired by WellPoint, rounded out the trio of top performers.

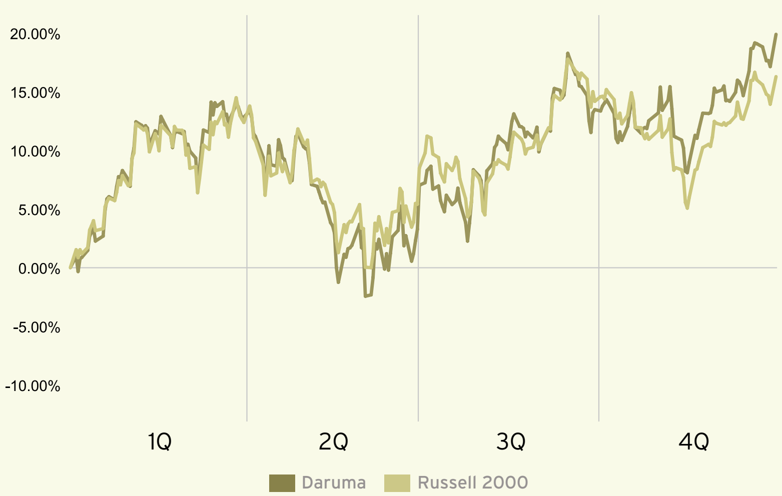
**Our Best and Worst Stocks**

| 4Q | | | 2012 | | |
|---|---|---|---|---|---|
| Best | Position Size | Contribution | Best | Position Size | Contribution |
| Brunswick Corp. | 4.1% | 1.0% | Lumber Liquidators | 3.6% | 5.2% |
| Pinnacle Entertainment | 3.0% | 0.8% | Maximus Inc. | 3.9% | 1.7% |
| Interface Inc. | 3.1% | 0.6% | AMERIGROUP | 0.0% | 1.6% |
| | Total | **2.4%** | | Total | **8.5%** |
| Worst | | | Worst | | |
| HealthSouth Corp. | 2.9% | -0.5% | Rovi Corp. | 2.4% | -1.1% |
| Pandora Media | 2.5% | -0.4% | Crocs Inc. | 3.2% | -1.1% |
| Crocs Inc. | 3.2% | -0.4% | Allscripts Healthcare | 0.0% | -0.8% |
| | Total | **-1.3%** | | Total | **-3.0%** |
| Best minus Worst | | 1.1% | Best minus Worst | | 5.5% |
| Rest of Portfolio | | 4.6% | Rest of Portfolio | | 14.4% |
| Daruma Small-Cap | | 5.7% | Daruma Small-Cap | | 19.9% |
| Russell 2000 | | 1.9% | Russell 2000 | | 16.4% |
| Return Difference | | 3.8% | Return Difference | | 3.5% |

Our worst three stocks (electronic programming guides maker Rovi -110 bps, Crocs -106 bps and IT solutions for health care provider Allscripts -84 bps) in total cost us 300 basis points. As you can see from the breakdown of best and worst stocks over the years that we include in every quarterly book, this is quite normal, even in strong markets.

We had 11 stocks generating over 100 basis points of performance, with only two detracting 100 basis points or more, as would be expected in a market that was up over 16% for the year. In aggregate the rest of the portfolio, net of outliers, generated 14.38%. Although we like it better when we beat across the entire portfolio, we will book these gains without complaint.

2012 Small-Cap Composite Performance Versus the Russell 2000

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### 2012 sector performance

The 2012 recovery in Small-Cap Financial Services proved to be a headwind for us. Our underweight in Financial Services cost us 336 bps, of which a whopping 202 bps were due to our zero weight in REITs. Our stock selection was excellent, with our return of over 32% handily beating the Index's 21% return. However, when financials are up more than the benchmark return for the year, it generates a large performance headwind for us, given the sector's large weight (23.5%) versus ours (4.0%). Again, this is not uncommon for us, given that we are chronically underweight financials and do not invest in REITs. Not owning any Utilities or Consumer Staples cost us another 67 basis points.

Our best sector contributors were Consumer Discretionary, Technology and Producer Durables, which generated an excess relative contribution of 419, 190 and 130 basis points, respectively. We also outperformed on a returns basis in these sectors.

We added 11 new positions during the year and sold nine. This is consistent with our historical patterns. Turnover ebbs and flows, but our average holding period remains 2.5 years. Our taxable clients appreciate the tax efficiency resulting from our long-term and lower turnover investment approach, especially in today's tax-hungry environment. Indeed, our best performing stocks reflect this. We bought Lumber in December of 2010, Maximus in April of 2010 and AMERIGROUP was first purchased in July of 2009, sold two years later, and then repurchased in August of 2011.

## Market perspectives

The market has been climbing a wall of worry, with the Russell 2000 quietly making an all-time high. Somehow that memo got lost in the all noise about the fiscal cliff. Generally, we feel constructive about our Small-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 and market sentiment continues to be negative. So, for example, while only 5% of all trading days last year for the Russell 2000 saw the spread between the high and the low of the day exceeding 2% (the lowest level seen since 1997)[1], and the Russell 2000 was up over 16% for the year, this is the second year in a row of Small-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

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[1] BofA Merrill Lynch Small-Cap Strategy Research 4 January 2013

need to 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 continuously 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.

*Past performance is not a guarantee of future results. Results are stated gross of management and custody fees, but after trading costs. This information supplements the Small-Cap Composite Presentation available on our website, which includes net performance data. Performance from inception (07/28/95) through 12/31/12. Please also see the disclaimers at www.darumanyc.com, which include a description of the comparison benchmark and the limitations on any comparison to the benchmark.*

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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.

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