First Quarter 2014

SMid-Cap Portfolio Commentary

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We had a breakeven quarter, up 2.27% versus 2.30% for the Russell 2500, a lag of 3 basis points. On a relative basis we were up in both January and February, with a nice lead of 217 basis points heading into March. The old chestnut, "in like a lion and out like a lamb," held true for our performance as well as March weather. What drove the portfolio higher in the first two months reversed course hard in the third, causing us to tread water for the quarter.

Our Best 3 Stocks

Ticker	Company	Description	Contribution
NXPI	NXP Semi	Semiconductor maker	0.9%
PCRX	Pacira	Pharmaceutical company	0.6%
INCY	Incyte	Biopharmaceutical maker	0.4%
		Best	**1.9%**

NXP Semiconductors (NXPI) rose 28% this quarter on the heels of an earnings beat and good 2014 guidance. NXP makes high-performance mixed-signal and standard semiconductor products. Even though NXP has many businesses growing faster than the industry, it has been accorded a discounted multiple. Reasons include 1) 24% of sales were standard products with slower growth rates; 2) post spin from Phillips, NXP was more levered than its peers; 3) there was an overhang of private equity ownership; 4) a slow down in some of their telecom markets due to a) lost share in handsets and b) China; and 5) it was an unknown and unseasoned stock.

Investors are now focused on the faster growth versus peers (10.5% vs. 2.5% year over year), the resulting margin expansion of roughly 300 basis points and the rapid increase in free cash flow that the company expects to return to shareholders. Share overhang is now a manageable 7%, the balance sheet is in good shape, and the company has been aggressively buying back stock. The valuation gap has closed considerably, although NXP still trades at a discount to its peers.

Drug maker Pacira Pharmaceutical (PCRX) was up 22% in the quarter. Adoption of its non-opioid post-surgical pain relief drug Exparel continues to spread virally. Exparel formulates bupivacaine (a generic pain drug that's been around since 1964) into an injectable foam. This foam, when properly placed at a surgical site, provides up to 72 hours of pain relief, and has revolutionized postsurgical pain control. Patients ambulate much faster (key to a speedy recovery) and do not suffer from opioid side effects, which can delay patient recovery, or even cause complications.

On the last day of the quarter Pacira received FDA approval for its new manufacturing facility, ensuring it can keep up with demand. Pacira is on the brink of profitability, and we believe that over time, in an ideal scenario, it can generate over $1 billion in revenues and $12 a share in earnings. In the meantime though, this will be a volatile stock, but one whose prospects justify the need for Dramamine from time to time.

Biopharmaceutical maker Incyte (INCY) shares rose and faded in tandem with the biotech/pharma group. Specific to Incyte, continued strong growth for its myelofibrosis drug Jakafi, the announcement of a phase III trial for pancreatic cancer and a promising clinical pipeline gave investors confidence that Incyte may well become than just a single drug company. Being able to treat solid tumors for a wide range of cancers as well as providing relief for rheumatoid arthritis patients would create a larger, more valuable drug franchise.

Incyte is a volatile stock, and as it continues to reinvest aggressively in developing its clinical pipeline, investors use a discounted cash flow valuation method. This makes the stock especially susceptible to small changes in interest rate assumptions. Like Pacira, we believe that the volatility is worth enduring as Incyte's long-term prospects are compelling.

Past performance is not a guarantee of future results. This information supplements the SMid-Cap Composite Presentation available on our website at http://www.darumanyc.com/disclosures/equity-composite-presentation-smid-cap/. The holdings identified do not represent all of the securities purchased, sold or recommended for clients. Please also see the additional disclaimers at the end of this commentary.

Our Worst 3 Stocks (%)

Ticker	Company	Description	Contribution
STNG	Scorpio	Petroleum products shipper	-0.5%
SFLY	Shutterfly	Digital photography products and services	-0.5%
BTU	Peabody	Coal producer	-0.4%
		Worst	**-1.4%**

A recent visit to petroleum products shipper Scorpio Tankers (STNG) gave us confidence that despite the 15% hit the stock took in the quarter, it is worth keeping in the portfolio. It is trading below net asset value, for one. For another, management is very focused on shareholder value. STNG is taking delivery of several new tankers a month this year to meet demand from new refineries opening up closer to points of production, as countries seek to boost revenues by capturing more economic value. This will result in a big increase in free cash flow, which we believe will dampen stock price volatility.

In addition, Scorpio traded tanker assets for ownership in shipping company Dorian, which is coming public soon, and those proceeds will be distributed to shareholders. Shipping rates are notoriously volatile, depending on what mix of product is being produced and where demand for that product lies.

Investors expected that rates would recover by now and became disappointed when they did not. The only sure thing about shipping commodity products is eventual mean reversion. We are willing to be patient.

Online photo product maker Shutterfly (SFLY) was down 16% in the quarter when 2014 EBITDA margin guidance was lower than last year's, despite strong organic revenue growth guidance of 15 to 17%. Investors were not expecting this much deleveraging from yet another cap ex investment year. Given the much faster growth rates in other internet stocks, plus the considerable seasonality of the business, investors moved on.

Delays in the full functionality and proper launch of photo storage service This Life were also a disappointment. Organization and retrieval of photos is a challenge given the explosion in digital photography. This Life, with its sophisticated facial recognition algorithms (among other ways of sorting and tagging photos), was meant to give Shutterfly the ability to organize, create and push out photo products to customers, based on an analysis of photo uploads.

Delays in a service that attracts more customers, makes them more loyal, and encourages them to transact more frequently, is not a good thing.

Coal producer Peabody Energy (BTU) was down 18% as met coal pricing continued to be weak in the first quarter. China, as the largest incremental buyer on the market, dictates the price for metallurgical coal, used to make steel. Demand was weak in the first quarter -- though Chinese steel production was more or less within expectations, large Chinese stockpiles were worked down, lessening the need to import coal. U.S. thermal coal (used to make electricity) fared better, as uneconomic mines were shut down, and coal inventory returned to more normal levels at electric utilities, helped by the cold weather and higher gas prices. We sold our position to make room for new ideas in the portfolio.

Best 3 Minus Worst 3 Stocks

	Best	1.90%
-	Worst	-1.36
=	**Best Minus Worst**	**0.54%**
+	Rest of Portfolio	1.73%
=	**Total Daruma**	**2.27%**
-	Russell 2500	2.30%
=	**Return Difference**	**-0.03%**

The net contribution of our top and bottom three outliers was only 54 basis points, and the rest of the portfolio lagged the benchmark, returning 173 basis points. On the plus side, we had 8 stocks that delivered double digit returns and only four whose returns were down double digits. Roughly 39% of the portfolio beat the index returns. Our sluggish results were broad-based and this is not an unusual breakdown in a flattish market.

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Return by Sector

Sector	Total Return (%) Daruma	R2500	Variation
Technology	7.54	0.40	7.14
Healthcare	7.37	4.09	3.28
Consumer Staples	1.47	-1.16	2.63
Producer Durables	0.06	2.40	-2.34
Utilities	--	7.42	-7.42
Materials & Processing	-0.91	2.38	-3.29
Consumer Discretionary	-2.19	-1.07	-1.07
Financial Services	-4.04	2.66	-6.70
Energy	-4.95	7.27	-12.22
Total	**2.27**	**2.30**	**-0.03**

Energy and Utilities, unlikely bedfellows, were the best performing market sectors. There was a period last year when investors stopped chasing income and started chasing growth -- with saber rattling in Eastern Europe and the always-anticipated-yet-strangely-continuing-to-impact-the-market prospects of QE ending, Utilities once again came into favor.

We have a zero weight in Utilities, as has been the case for years. As seekers of change in the rate of change in fundamentals, industries like Utilities whose returns are mandated are typically not fertile ground for ideas.

Severe winter weather caused a larger-than-expected draw down in natural gas storage, boosting natural gas prices. Even though gas production did not decline as quickly as expected when gas prices bottomed, drilling did eventually start to slow and supply is moderating.

It was largely the sharp uptick in demand though, that goosed stock prices up. Whether this increase in natural gas prices is sustainable remains up for debate.

On a returns basis we outperformed in 3 out of the 9 Russell sectors, Technology, Healthcare and Consumer Staples. Their performance was broad based, as 4 out of 5 of our Tech stocks, 5 out of 8 of our Healthcare and 1 out of 1 of Consumer Staples beat the index. Our Energy returns were the worst, with 2 out of 3 of our holdings (Peabody and QEP Resources) being underwater in the quarter's second best performing index sector.

Contribution by Sector

Sector	Contribution (%)			Ending Weight (%)		
	Daruma	R2500	Variation	Daruma	R2500	Variation
Healthcare	1.66	0.47	1.19	22.4	10.6	11.8
Technology	1.28	0.06	1.22	17.0	11.8	5.2
Consumer Staples	0.04	-0.04	0.08	3.2	2.4	0.8
Producer Durables	0.04	0.34	-0.30	20.4	15.3	5.1
Utilities	--	0.40	-0.40	--	5.5	-5.5
Materials & Processing	-0.02	0.21	-0.23	11.3	8.3	3.0
Financial Services	-0.13	0.63	-0.76	2.9	25.1	-22.2
Energy	-0.21	0.40	-0.61	2.6	5.8	-3.2
Consumer Discretionary	-0.39	-0.17	-0.22	19.0	15.2	3.8
Total	**2.27**	**2.30**	**-0.03**	**98.8**	**100.0**	**-1.2**

Our contribution results were similar. We were overweight all three of our best returning sectors, which goosed those results. Our biggest contributors, Technology and Healthcare, benefited from better returns in the case of the former, and a bigger overweight in the case of the latter. Our biggest deficit on a contribution basis was in Financial Services, largely due to our substantial underweight, exacerbated by the the 4% price decline in our only financial holding, fleet payment processor and one-time MasterCard issuer WEX.

Changes in Positions

We sold out of two energy positions Peabody Energy and Ultra Petroleum (UPL). Over its holding period UPL contributed a total of 30 basis points while BTU detracted 101 basis points. **We bought three stocks: adhesives manufacturer H.B. Fuller (FUL), apparel maker PVH Corp. (PVH) and water infrastructure and services company Xylem (XYL).**

All three new positions are not fast-growing, but can drive earnings and cash flow from the sizable operating improvements they have underway. Investors continue to reward companies whose capital is being deployed wisely, as well as those whose free cash flow growth is accelerating. We should be well-rewarded if results come through in line with expectations.

Minneapolis-based Fuller has been undergoing a multi-year operational transformation, which included a large European acquisition, Forbo. We are nearing the tail end of the integration process, and expect to see free cash flow improve materially going forward. We believe margins still have room to grow as well, as with returns. Historically Fuller did not leverage its size, with no shared services and product proliferation within each little geographic fiefdom. This created a drag on past results, and as FUL continues to address these, margins and cash flow will continue to improve.

Apparel maker PVH has a tremendous opportunity ahead to revitalize the acquired Calvin Klein franchise, which had been moved downmarket under Warnaco's prior stewardship. Calvin Klein's leadership had been paid on revenue growth rather than on profitability or returns, explaining many of the bad business decisions made by prior management. Under PVH's tutelage we expect profit increases, sales growth and debt paydowns to drive cash flow growth.

Water infrastructure product and service company Xylem, a spin-off from ITT Industries, was hit hard when municipal infrastructure budgets were slashed as a result of the financial crisis. However, Xylem's large recurring revenue in parts and service continued to do well. XYL is also undergoing the operational streamlining that is typical of spin-offs once they ditch the mother ship.

Market Outlook

SMid-cap valuations continue to be at the high end of their absolute and relative historical levels. The higher beta, higher growth stock meltdown experienced in March and continuing into April has been frustrating. The best ideas have not come down enough to add to aggressively, but are down enough to cause damage to the portfolio.

The end of easy money does mean that stocks whose discounted cash flow (DCF) valuations are sensitive to small changes in interest rate assumptions will get crushed, as can be seen by the vicious pull back in the biotech sector. In a slow growth world, fast growing companies are bid up. With the prospects of a U.S. economy perking up, investors are now more interested in companies whose growth rates will be boosted by a rising economic tide. Tremendous earnings and cash flow will result from the operating leverage that a faster top line brings.

We are not saying that economic activity will be robust necessarily, thanks to globalization and developed world demographics. **We believe that companies that are able to grow and earn returns above their cost of capital will be sought after, no matter whether the source is internal or external.**

Macro predictions from bottom-up stock pickers are notoriously unreliable, so we continue to focus on our prime directive: find no more than 35 companies whose fundamentals look like they will accelerate, causing their stock to outperform the Russell 2500.

Those that have a better mouse trap, own niche pockets of rapid growth, undergo operational transformations, or whose industry landscape is changing for the better, all have the potential to drive your relative portfolio returns, no matter the market environment.

As ever, we continue to chase elephants and scour our investable universe for those stocks we believe have 50% upside with a 3 to 1 reward to risk ratio.

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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 SMid-Cap Equity strategy is the Russell 2500. The Russell 2500 includes approximately 2500 of the smallest U.S. common stocks based on a combination of their market cap and current membership in the Russell 3000. The Russell 2500 Value Index includes those Russell 2500 Index companies with lower price-to-book ratios and lower forecasted growth values, while the Russell 2500 Growth Index includes those with higher-price-to-value ratios and higher forecasted growth values.

The SMid-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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