Small-Cap Portfolio Commentary

DARUMA
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Our small-cap composite was up 1.27% versus 1.12% for the Russell 2000, eking out a 15 basis point lead. Breaking even relative to the benchmark is a teeny victory, but we'll gladly take it, as only 54% of small-cap core funds managed to beat the index.[1] It was an erratic quarter, with the Index down 2.8% in January (we trailed by 62 bps), up 4.7% in February (we led by 195 bps), and then down 0.7% in March (we lagged by 104 bps).

Trailing 2 out of 3 months in the quarter does not give us the warm and fuzzies, but there were cross-currents in the market, and we do not try to surf every market trend. **Sticking to our discipline has worked for us over the long haul, even if our holdings are at times out of favor.**

1. Bank of America Merrill Lynch, Steve DeSanctis, "First Quarter Performance Recap," April 2, 2014

Our Best 3 Stocks

Ticker	Company	Description	Contribution
PODD	Insulet	Disposable insulin pump maker	0.7%
PCRX	Pacira	Pharmaceutical company	0.7%
CRZO	Carrizo	Oil and gas producer	0.6%
		Best	**2.0%**

Disposable insulin pump maker Insulet (PODD) was the best performing stock in the portfolio this quarter, up 28%. 2013 was a year of product transition, where Insulet converted their existing customer base and ramped up production of their new, smaller pump. This dampened profitability, and created execution risk. Investors are now more willing to give Insulet full credit for its growth since the obvious potential bumps in the road are behind them.

Progress on adding continuous glucose monitoring to the pump was welcome news, as the marketplace craves an integrated device, and not having one would put Insulet at a competitive disadvantage.

In addition the news that Insulet partnered with other companies to dispense drugs other than insulin (e.g. oncology and fertility) via the disposable pump gave investors confidence that PODD's addressable market may be more diverse and larger than just the Type I diabetes market.

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 for a long time) 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. These better outcomes are so compelling that use of Exparel is spreading not just from hospital to hospital, but also from surgical specialty to surgical specialty within a hospital.

PCRX's rapid growth prospects attracted investors playing in the first quarter's biotech rally. In addition, 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 capture enough share to generate $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.

Energy stocks had a good quarter, and oil and gas producer Carrizo (CRZO) rose over 19% with the tide. Carrizo has an excellent position in the Eagle Ford, which investors are finally giving them credit for, as they continue to book promising well results.

CRZO has been steadily improving efficiencies, which lowers well costs and drilling times, and moving into "manufacturing mode," which makes for steadier cash flows. When coupled with a shift to more liquids (more valuable than dry gas) and faster production growth, investors are willing to pay more for the stock.

Our Worst 3 Stocks

Ticker	Company	Description	Contribution
DGI	Digital Globe	Satellite imagery company	-1.0%
STNG	Scorpio	Petroleum products shipper	-0.5%
SFLY	Shutterfly	Digital photography products and services	-0.4%
		Worst	**-1.9%**

Satellite imagery company Digital Globe (DGI) was down 30% in the quarter on disappointing fourth quarter results and 2014 guidance. We believe this is excessive. After benefiting in 2013 from the considerable cost synergies resulting from acquiring key competitor Geoeye, the company is facing temporary headwinds. 70% of the guidance miss is due to a two-month delay in the launch of a new satellite, 25% is due to a slowdown of imagery buying in emerging markets (Russia, Turkey, China) and 5% is due to aggressive pricing from a competitor in a few commercial markets.

DGI remains a 'show me' stock for now. We believe that the potential lifting of a restriction by the US government on selling higher-resolution images, and the continued development of the company's data analytics and commercial applications, will lead to improved results.

Another source of growth is taking shape within the U.S. government market by taking out middlemen who provide no valueadded services. In addition, after the launch of the new satellite later this year, DGI will generate substantial free cash flow which can be returned to shareholders, as it enjoys a multi-year capital expenditure "holiday."

A recent visit to petroleum products shipper Scorpio Tankers 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 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 was 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.

Best 3 Minus Worst 3 Stocks

	Best	2.0%
-	Worst	-1.9%
=	**Best Minus Worst**	**0.1%**
+	Rest of Portfolio	1.2%
=	**Total Daruma**	**1.3%**
-	Russell 2000	1.1%
=	**Return Difference**	**0.2%**

The net contribution of our winners and losers was 12 basis points, paltry even for a lackluster quarter. The contribution from our winners was satisfactory, though not stellar, but it was the big losers that hurt us.

The rest of the portfolio beat the Index, and so did its job. 56% of the weighted portfolio and 22 positions beat the benchmark. 14 positions were down and 2 were up but trailed.

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Return by Sector

Sector	Total Return (%) Daruma Small-Cap	R2000	Variation
Energy	12.19	6.93	5.26
Healthcare	11.04	3.86	7.18
Consumer Staples	6.45	2.98	3.47
Producer Durables	0.43	1.15	-0.72
Financial Services	--	0.81	-0.81
Utilities	--	4.26	-4.26
Technology	-1.77	0.39	-2.16
Consumer Discretionary	-2.17	-3.45	1.28
Materials & Processing	-4.21	0.70	-4.91
Total	**1.27**	**1.12**	**0.15**

On a returns basis we beat in 4 out of 9 sectors. The best were Healthcare, (not surprising given that two out of our top three stocks were Healthcare names) and Energy (our third-best stock contributor). Given the drubbing Consumer Discretionary took in the market and our overweight, we are gratified that our sector returns outperformed those of the Index.

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.

Contribution by Sector

	Contribution (%)			Ending Weight (%)		
Sector	Daruma Small-Cap	R2000	Variation	Daruma Small-Cap	R2000	Variation
Healthcare	1.50	0.57	0.93	14.6	13.4	1.2
Energy	0.78	0.38	0.40	6.8	5.6	1.2
Producer Durables	0.14	0.14	--	14.9	14.4	0.5
Consumer Staples	0.06	0.09	-0.03	0.8	3.3	-2.5
Utilities	--	0.17	-0.17	--	4.1	-4.1
Financial Services	-0.02	0.15	-0.17	5.9	24.1	-18.2
Consumer Discretionary	-0.32	-0.51	0.19	18.2	13.6	4.6
Technology	-0.38	0.07	-0.45	25.3	14.3	11.0
Materials & Processing	-0.50	0.05	-0.55	11.4	7.2	4.2
Total	**1.27**	**1.12**	**0.15**	**97.9**	**100.0**	**-2.1**

On a contribution basis our best sectors were Healthcare and Energy. Sometimes our best performing sectors on a returns basis are not our best contributors if our underweight is material, but this was not the case this quarter.

Our overweight in Materials & Processing did not help however, as only one (specialty plastics maker A. Schulman) out of four of our stocks beat the Russell 2000 sector.

As for Technology, 5 out of 8 stocks beat the index sector, but our overall returns did not, thanks to the impact of Digital Globe, marketing services provider Acxiom (whose 7% decline cost us 23 basis points) and Semiconductor maker Microsemi (flat for the quarter).

Changes in Positions

We completed the sale of internet radio provider Pandora (P), interventional cardiology catheter maker Volcano (VOLC), and homebuilder Standard Pacific (SPF). Pandora was our best contributing stock in 2013, generating 389 basis points of performance.

We sold VOLC and SPF largely to make room for more compelling ideas. Both contributed to performance over their holding periods (42 and 2 basis points respectively) but we needed to make room in the portfolio.

Our new buys include handbag and accessories maker Vera Bradley (VRA) and internet media company Bankrate (RATE). We owned VRA unsuccessfully in the past, but believe that this time's the charm, what with new management making what we think are all the right moves. Bankrate is also under new leadership, and we expect to see a continued recovery in its insurance business, as well as better margins driven by better execution. We are in the process of building positions in online education provider K-12 (LRN) which we used to own and is under new management, and natural foods company Sunopta (STKL).

Market Outlook

Small-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 rising rate environment, especially one that's not accompanied by robust economic activity (hello globalization and developed world demographics!), companies that are able to grow and earn returns above their cost of capital will be sought after.

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 2000.

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 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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