First Quarter 2015

SMid-Cap Portfolio Commentary

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Founder, CEO & CIO

Daruma returned 1.7%, lagging the benchmark by 3.5%. It was a tough quarter for us. In January, we got hit hard (-2.9%) when equities across the board declined. In February, we rebounded nicely (+4.8%) as some of our companies reported good fourth quarter results.

Then in March (-0.08%) we got hit by a "left field event"—DIY flooring company Lumber Liquidators (LL), a stock that had been a winner for us in our small-cap portfolio in the past, was battered by a 60 Minutes segment laden with accusations related to product safety.

SMid-caps rose to the top of the heap in the first quarter as the Russell 2500 Index, up 5.2%, beat out small, mid and large-caps. The Russell 2500 Growth Index came in well ahead of Value (7.4% vs. 3.0%) as the largest companies with strong earnings growth rates led returns.

All of this made for a frustrating quarter, but we remain committed to our steady approach. Our patient, long-term view mixed with our fundamental research process gives us the conviction to stay the course believing that we're in a marathon, well-equipped to handle all its twists and turns and to make it across the tape strong and healthy.

Our Best 3 Stocks

Ticker	Company	Description	Contribution (%)
NXPI	**NXP Semiconductors**	semiconductor manufacturer	1.0
OC	**Owens Corning**	building products and fiberglass	0.7
BDC	**Belden**	signal transmission supplier	0.6
		Best	**2.3%**

NXP Semiconductor (NXPI) continued its streak of delivering industry-leading results with another quarter of solid sales and earnings growth. However, it was the early March announcement of its intent to merge with Freescale Semiconductor that boosted the stock, further driving a 31% increase for the quarter. With very little product overlap between the two companies, there is a lot to like about the deal.

The combined company will be the fourth largest semi supplier globally and the largest semi vendor to the auto market. In addition, it's poised to be a critical provider to the emerging Internet of Things category. Expense synergies look conservative and achievable and the free cash flow generation of the combined business should allow for a quick deleveraging of the balance sheet. Despite the strong stock performance, the valuation remains attractive and we believe there is additional upside for the shares.

The shares of building materials maker **Owens Corning (OC)** have been powered by continued progress in insulation and composites and improving prospects for roofing after a challenging 2014. If pricing holds, lower asphalt costs (driven by lower oil prices) could result in meaningful roofing operating margin expansion in the back half of the year.

The Industry channel checks confirm that roofing manufacturers have not only discounted less during the typically promotional winter buying season, but have recently announced price increases. If industry pricing discipline holds, we think current earnings estimates are too low.

Belden's (BDC) solid outlook for 2015 caused this signal transmission solutions provider's price to rise by 19%, despite earlier investor concerns around potential foreign currency weakness. BDC's multi-year profit improvement plan remains firmly on track and the recent Tripwire acquisition only accelerates its transformation.

With Belden's end markets showing more signs of improvement, we expect continued margin expansion and the initial accretion from the Tripwire deal to be important drivers to achieving our 2015 forecasts. We applaud management's strategy of reducing its lower-margin cable product exposure and feel the stock has continued room to run.

Our Worst 3 Stocks

Ticker	*Company*	*Description*	*Contribution (%)*
LL	**Lumber Liquidators**	do-it-yourself flooring company	-2.3
PVH	**PVH Corp.**	global branded apparel	-0.5
ACXM	**Acxiom**	direct marketing services	-0.4
		Worst	**-3.2%**

Shares of **Lumber Liquidators (LL)** sold off sharply (-57%) during the quarter after a 60 Minutes segment alleged product safety concerns about laminate flooring products imported from China.

Lumber Liquidators is a company we know well, having owned it previously and very profitably in our small-cap portfolio. In the past, management has been transparent, and over the last 18 months has invested heavily in serving the integrity of its supply chain by adding people, finishing lines in the U.S. and a testing facility. This is not a management team that cuts corners to boost profits.

The company made sales progress early in the year after 2014's supply chain disruptions, and we initially added on weakness. However, their mid-March business update call noted a sharp drop in sales, orders and gross profit margins after the 60 Minutes segment aired.

Lumber LIquidators stands by its product safety, but we saw potential for the brand damage caused by the 60 Minutes report, combined with LL's long sales cycle, high ticket, low transaction frequency and lowered guidance, to create additional earnings and valuation risk not reflected in the stock price.

Global lifestyle apparel company **PVH's (PVH)** stock has been under pressure since the beginning of the year due to the weaker Euro (more than a third of the company's sales are in Europe). The company is seeing foreign exchange headwinds in the near-term (already reflected in forward year guidance), but we think the organic demand trends for Calvin Klein and Tommy Hilfiger brands are healthy despite the challenging retail environment.

Also, Calvin Klein Jeans is seeing momentum in its turnaround: the U.S. is experiencing higher average unit retail prices (up 15% year over year), remodeled department store "shops" have noted substantial productivity gains and Europe is in the initial phase of a recovery.

After a solid performance last quarter, shares of this marketing service provider pulled back in Q1 as **Acxiom's (ACXM)** legacy product line struggles to grow. Recent leadership changes for this business unit should help address these challenges, along with a return to a vertical-specialized, consulting-led sales approach.

We remain very encouraged with the impressive progress of ACXM's digital-focused solutions. In addition, we believe its connectivity offering is quickly becoming the industry standard for marrying offline and online data for more effective marketing campaigns. We expect a return to modest growth for the legacy product line, which, when coupled with continued success for its digital offering, should lift the shares higher.

Best 3 Minus Worst 3 Stocks

The net result of our winners and losers was a detraction of 92 basis points. Our best three contributed 231 basis points while our worst three lost 322 bps, 231 of which were due to Lumber Liquidators.

	Contribution (%)
Best	2.3
Worst	-3.2
Best Minus Worst	-0.9
Rest of Portfolio	2.6
Total Daruma	1.7
Russell 2500	5.2
Return Difference	-3.5%

We are not pleased to have a net negative from our top three and bottom three stocks in an up market, but it was hard to overcome Lumber Liquidators' 231 basis point hit. The rest of the portfolio was only able to generate 261 basis points of contribution. 14 stocks beat the Index, but were overshadowed by the 18 stocks that trailed.

Return by Sector for the First Quarter (%)

Sector	Daruma SMid-Cap	R2500	Variation
Energy	8.50	0.66	7.84
Materials & Processing	11.74	4.51	7.23
Financial Services	8.36	3.70	4.66
Utilities	-	-2.53	2.53
Technology	5.44	5.29	0.15
Producer Durables	0.75	3.27	-2.52
Consumer Staples	-	5.54	-5.54
Healthcare	5.37	14.43	-9.06
Consumer Discretionary	-8.70	5.95	-14.65

Contribution by Sector for the First Quarter (%)

Sector	Daruma SMid-Cap	R2500	Variation
Materials & Processing	1.19	0.36	0.83
Energy	0.34	0.03	0.31
Utilities	-	-0.13	0.13
Technology	0.51	0.62	-0.11
Consumer Staples	-	0.14	-0.14
Producer Durables	0.12	0.45	-0.33
Healthcare	1.33	1.79	-0.46
Financial Services	0.21	0.97	-0.76
Consumer Discretionary	-2.02	0.94	-2.96
Total	**1.68**	**5.17**	**-3.49**

Returns & Contribution to Performance by Sector

Biotech stocks powered the Healthcare sector, up 14.4%, leading the Russell 2500's performance during the quarter and adding 179 basis points to its 5.2% return.

Consumer Discretionary (+6%) followed and Consumer Staples came in third (+5.5%). These two sectors combined added 108 basis points to performance. Technology was next, posting a +5.3% return and Materials & Processing followed (+4.5%). Utilities was the only sector in the red, down 2.5%.

Daruma beat the Russell 2500 in 4 out of 7 sectors owned. We did not own any Consumer Staples or Utilities companies. Materials & Processing, led by Owens Corning (+22%) and Belden (+19%), two of our top 3 producers, was our best performing sector, up 12%. Energy (+9%) was next, followed by Financial Services (+8%). Technology and Healthcare each clocked in at +5%. Our worst performing sectors were Producer Durables, up 0.8%, and Consumer Discretionary, down 9%.

Healthcare gave us our best contribution to performance (+133 bps) but since we lagged the benchmark return by 9%, we lost 46 basis points of relative performance. Because we were overweight in Materials & Processing and we beat the benchmark returns (12% vs. 5%), this sector contributed 119 bps to Daruma's performance and 83 bps in relative performance.

While our returns in Financial Services were higher than the Index (+8% vs. +4%), our vast underweight in the sector (since we do not own REITs, which occupy 9% of the Index weight) caused us to lose 76 basis points in relative performance. Consumer Discretionary hurt us the most, driven by the impact of Lumber Liquidators. We lost 202 bps in absolute contribution to the Index sector and 296 basis points relative.

Market Outlook

Seven years after the Great Financial Crisis, this late cycle market is being buffeted anew by macro concerns: the parabolic dollar, sinking oil prices and the end of the commodity supercycle as China's economy matures.

Small-caps' outperformance relative to large has been driven in part by the Russell 2000's much lower energy exposure (5% vs. 12% for the S&P 500 at the end of the third quarter '14 before oil prices tanked), and in part because the Index is less vulnerable to foreign exchange fluctuations.

We stock pickers have a horror of markets stirred up by macro winds, as the differences among companies no longer matter in those circumstances. That this market is long in the tooth is more of an issue however. A bear market produces a surfeit of bargains– by the seventh year of an expansion it's slim pickings, as big misvaluations gaps have closed.

This should not be considered a recommendation to buy or sell any security.

To quote one of my favorite market strategists, Michael Goldstein,

> *As a rule, stock pickers fare best in recessions and in the early phases of recoveries, when there are a lot of obvious opportunities to choose from. The breadth of stocks outperforming the market tends to be above-average in those settings and is worst around business cycle peaks... Market cycles have a lot to do with the fact that investors underestimate both operating leverage and the persistence of good fundamentals, and as they progress, analyses of trends should carry greater weight in decision making.*[1]

As the cycle ages, the breadth of the market narrows; with fewer stocks driving returns, valuation matters less, and momentum trends matter more. "Mo" is good until it stops, and then it's "look out below!". Maybe my pals in the business are being kind to me because of the rough patch we've been going through, but everyone I speak to is wearing their flak jacket and bemoaning performance.

In terms of valuation, the Russell 2000 was trading at 1.23 standard deviations above its 30 year average at the end of February. Although this is down from the 1.49 valuation at the end of 2013, it is on the high end of the range. This is relatively better value than the S&P 500, which at the end of February was trading at 1.59 standard deviations over its 30 year average.

This difference in relative valuation between the two indices is the cheapest since the end of the Tech bubble, and is usually a harbinger of small-cap relative outperformance in the following twelve months.[2] One note of caution though: the Russell 2000 typically falls 13% after the first Fed rate hike, compared to 10% for the S&P 500. It will be interesting to see what will happen when the world's most long-awaited shoe finally drops.

This has been a brutal start to the year for us on a relative basis. Late cycle markets are a conundrum– what's obviously cheap has a lot of hair on it while what's working gets so expensive that the slightest miss is severely punished. Risk/reward gets skewed: the upside seems small relative to a yawning downside.

We have been here before, both in terms of dealing with the frustrations of late market cycles and in terms of underperformance. In the past we always recovered one stock at a time, working our way out of the rough patch the same way we found ourselves in it. Sticking to our investment process and discipline is paramount, which we will continue to do with urgency, intensity and thoughtfulness.

1. Michael Goldstein, Empirical Research Partners, Portfolio Strategy (March 2015).
2. Lori Calvasina, Credit Suisse, US Equity Strategy (March 4, 2015).
3. Calvasina.

Firm Update

Meet Daniel Sendrowitz, our Chief Compliance Officer

After a thorough and thoughtful search, we are delighted to announce that Dan Sendrowitz has joined Daruma as Chief Compliance Officer. Dan shares our belief that compliance touches every employee and is an essential part of the DNA of an investment firm.

Dan is a collaborative leader who, together with Jesse Lindenberger-Schutz, will work with Daruma to maintain and further develop our compliance culture, ensuring that compliance so permeates our organization that it is like the fat in a well-marbled steak.

Before joining Daruma, Dan was Senior Compliance Officer and Co-Head of U.S. Compliance for Och-Ziff Capital Management (a multi-billion dollar, publicly traded multi-strategy investment firm). Prior to his nearly 8 years at Och-Ziff, Dan worked for Western Asset Management and Citigroup Asset Management in a variety of compliance roles, acquiring a broad range of experience in the process. Dan married his high school sweetheart, has three children and is also an overachiever, graduating *summa cum laude* from C.W. Post Long Island University with a 4.0 GPA.

The Big Move

Back in 2002, moving into our space overlooking Bryant Park during a recession and a bear market was a massive, at times daunting, milestone for us. Having a beautiful space that gave us breathing room made a huge difference in our productivity and our collective happiness, and heralded a new chapter in Daruma's development.

Now that we've doubled our staff in the twelve years since, it was time to find a new home for Daruma. We just moved into our new digs on the 21st floor of the Hippodrome building at 43rd Street and 6th Avenue. Everyone is looking forward to the productivity that more private space and elbow room will bring, while still enjoying the large amount of collaborative space that is key to our culture.

A big shout out to Cassidy Cruz, our office manager, who has supervised a multi-month build out that is both on schedule and under budget. Photos from our move can be found later in the book. Please come visit us soon.

Snapshot of the SMid-Cap Landscape

Ron Viener
Director of Trading

The first matrix on the following page (Exhibit 1) is the Russell 2500 sorted into deciles of performance according to different characteristics, some fundamental and some sentiment-based. The percentage in each box is the performance of that attribute (e.g. beta) for that decile. The second matrix (Exhibit 2) is for 2014 year-end results.

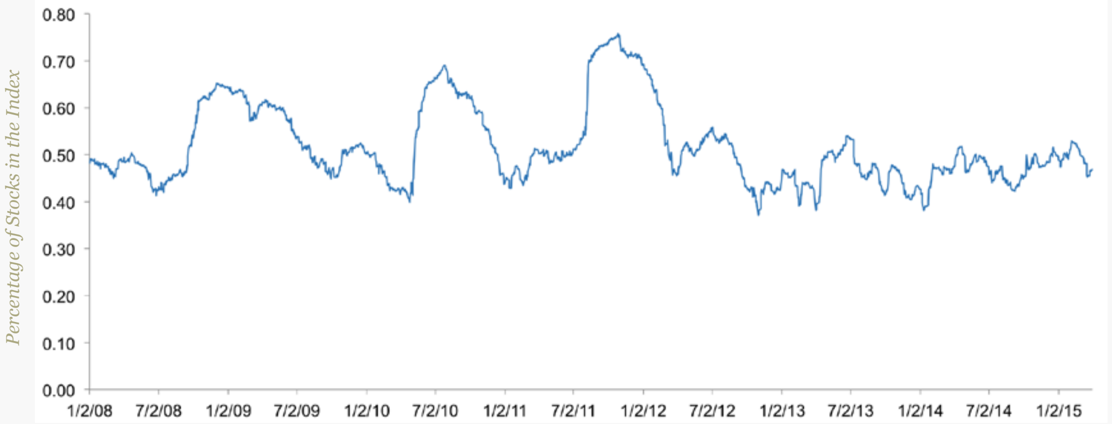
The chart below (Exhibit 3) shows the correlation of the index' constituents to the Russell 2500 (average 60-day rolling correlation).

Many of the same trends that fueled 2014 performance continued for the Russell 2500 in the first quarter of 2015. The best performing stocks last year continued to do well this quarter, as "the trend was your friend" and investors continued to reward the fastest growing companies. This meant that value stocks, (e.g. those with low p/e multiples and high dividend yields), dragged in the first quarter, as they did in 2014.

As you can see, sell-side analyst ratings have been largely accurate both in the quarter and last year. This is not surprising, given that correlations among stocks have reverted back to normal levels (see Exhibit 3), just as the Index made new all-time highs. The moments when stocks all move in an all-in-one fashion are notable, and usually occur at macro inflection points, which are often coupled with market lows.

As the market cycle ages, the conditions improve for stock picking as investors start to differentiate among companies. Over time breadth gets narrower, valuations get pushed, and the consequences of not meeting expectations are dire.

Average 60-Day Rolling Correlation of the Russell 2500 to Its Constitutents *(as of March 31, 2015)*



This chart shows the 60-day rolling correlation of the one-day price change of a stock in the benchmark compared to the one-day price change of the whole benchmark, averaged against all stocks in the index for that point in time.

Exhibit 3

Sources: CornerStone Macro & Daruma Capital Management

Russell 2500 Performance of Attributes by Decile (%)

First Quarter 2015 (as of March 31, 2015)

	Deciles									
	1	2	3	4	5	6	7	8	9	10
Market Cap Largest to smallest	9.4	6.8	7.9	5.1	3.9	6.4	3.0	0.6	0.0	-13.4
P/E Ratio Lowest to highest[1]	-4.2	-0.3	3.1	3.1	7.0	8.2	7.1	9.2	-	0.9
Dividend Yield Highest to lowest[2]	-1.3	1.5	3.8	4.9	7.3	-	-	-	-	3.1
Short Interest Lowest to highest	4.9	4.1	3.2	2.4	2.4	2.2	2.7	3.1	3.7	1.0
Beta Lowest to highest	2.6	4.5	4.8	3.9	5.0	2.5	1.8	3.8	1.3	-0.6
Sales Growth Best to worst	9.7	5.3	3.9	4.1	4.9	2.8	1.3	1.0	-3.2	-6.8
Analyst Ratings Best to worst	2.7	7.4	5.7	5.3	3.4	2.9	2.7	2.0	-0.5	-3.3
Institutional Ownership Most to least[3]	1.8	2.4	5.0	5.0	3.7	3.4	3.6	3.2	0.7	0.6
% Change in 2014 Best to worst[4]	26.8	11.0	6.2	6.4	4.0	2.2	0.3	-2.5	-5.9	-18.9

Exhibit 1

Year-End 2014 (as of December 31, 2014)

	Deciles									
	1	2	3	4	5	6	7	8	9	10
Market Cap Largest to smallest	22.2	14.6	12.0	8.3	12.6	8.8	1.2	5.6	-1.2	-26.1
P/E Ratio Lowest to highest[1]	-6.7	1.6	9.2	10.2	10.9	18.5	13.3	9.9	-	-1.5
Dividend Yield Highest to lowest[2]	4.4	9.3	5.4	9.3	12.4	-	-	-	-	4.6
Short Interest Lowest to highest	12.2	13.1	12.7	6.8	7.2	7.8	5.2	6.5	-0.8	-10.6
Beta Lowest to highest	16.3	15.1	9.3	13.0	2.7	5.4	2.9	-2.4	0.4	-2.3
Sales Growth Best to worst	16.7	10.0	2.1	8.9	8.5	12.2	6.2	6.1	-7.8	-16.2
Analyst Ratings Best to worst	9.5	19.5	12.8	6.1	7.2	3.1	3.8	1.3	2.5	-4.7
Institutional Ownership Most to least[3]	1.3	6.6	7.6	7.5	8.0	8.5	9.1	3.9	4.6	2.4
% Change in 2014 Best to worst[4]	44.3	25.1	15.5	12.3	5.9	3.4	-4.4	-10.6	-21.3	-47.8

Exhibit 2

The red circle indicates the worst-performing decile for the category.

The green circle indicates the best-performing decile for the category.

1. Decile 10 of *P/E Ratio* is made up of all stocks that have no P/E.
2. Decile 10 of *Dividend Yield* is made up of all stocks that pay no dividend.
3. *Institutional Ownership* may be over- or under-stated due to timing of filings.
4. Decile 10 of *% Change in 2014* is made up of stocks with no complete 2014 performance.

Sources: Russell Investments & Daruma Capital Management

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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. Performance for 2014 is not yet audited and subject to change upon audit. 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 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 Small-Cap and SMid-Cap Equity strategies are concentrated strategies that are 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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