Small-Cap Portfolio Commentary

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Daruma's small-cap composite barely made it over the finish line in the first quarter (+0.24%), lagging the benchmark Russell 2000 by 408 basis points. It was a tough quarter for us. In January, we got hit hard (-6.1%) when equities across the board declined. In February we rebounded nicely (+7.8%) as some of our companies reported good fourth quarter results. Then in March (-1.0%) we got hit by a "left field event"— DIY flooring company Lumber Liquidators (LL), a stock that had been a winner for us in the past, was battered by a 60 Minutes segment laden with accusations related to product safety.

Small-caps beat out large-caps in the first quarter as the Russell 2000 climbed 4.3% while the Russell 1000 climbed 1.6%. Growth came in well ahead of value with the Russell 2000 Growth Index returning 6.6% vs. 2.0% for the Russell 2000 Value Index as investors rewarded high-quality stocks sporting expensive valuations with strong earnings and sales growth rates.

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 (%)*
OXM	**Oxford Industries**	branded specialty apparel	1.0
SHLM	**A. Schulman**	plastics and resin supplier	0.7
HLS	**HealthSouth**	inpatient rehabilitation services	0.6
		Best	**2.3%**

Branded specialty apparel company **Oxford Industries (OXM)** was our best performer (up 37%) and added 97 basis points to performance. Shares of OXM rebounded significantly on improved fourth quarter earnings results led by its core brands Tommy Bahama and Lilly Pulitzer.

We were encouraged by the results because they demonstrated the pricing power of Oxford's brands, especially in an extremely tough retail environment. Additionally, management's decision to formally divest the Ben Sherman brand, which contributed an operating loss, supported solid 2015 EPS guidance.

Shares of **A. Schulman (SHLM)**, a leading supplier of plastic compounds and resins, jumped 20% in the quarter despite a soft start to the year on concerns the uncertain European economic environment would dampen results. In the past, SHLM has deftly managed end-market uncertainty through proactive cost reductions. We used the weakness to add to our position.

Return by Sector for the First Quarter (%)

Sector	*Daruma Small-Cap*	*R2000*	*Variation*
Energy	6.68	-1.93	8.61
Producer Durables	7.96	1.25	6.71
Materials & Processing	9.18	5.30	3.88
Utilities	-	0.89	-0.89
Financial Services	-1.41	1.77	-3.18
Technology	-2.75	5.13	-7.88
Consumer Discretionary	-5.37	4.97	-10.34
Healthcare	0.40	12.45	-12.05
Consumer Staples	-10.41	2.10	-12.51

Contribution by Sector for the First Quarter (%)

Sector	*Daruma Small-Cap*	*R2000*	*Variation*
Producer Durables	1.23	0.15	1.08
Materials & Processing	0.93	0.34	0.59
Energy	0.30	-0.06	0.36
Utilities	-	0.04	-0.04
Consumer Staples	-0.28	0.06	-0.34
Financial Services	-0.02	0.44	-0.46
Technology	-0.79	0.75	-1.54
Healthcare	0.18	1.88	-1.70
Consumer Discretionary	-1.31	0.72	-2.03
Total	**0.24**	**4.32**	**-4.08**

We were rewarded as results were better than expected and investors cheered the news of the acquisition of Citadel Plastics, lifting the shares 45% from their January lows. In addition to impressive earnings accretion, Citadel meets the important strategic initiatives that underpin our investment thesis– that is, increased scale in the North American market, diversification into faster growing end-markets, and a stronger contribution from higher-margin niche products.

Inpatient rehabilitation facility company **HealthSouth (HLS)** was up 16% in the first quarter. There was no single driver of the stock's strong performance– rather, its good results were a continuation of strong execution on management's part. The company continues to drive respectable organic volume growth while also adding patient capacity inorganically by building onto existing facilities and buying underperforming facilities from struggling peers.

The company also continues to improve its free cash generation. During the quarter it essentially swapped $300 million of high interest rate debt to a rate lower by 300 basis points. Management also finally pulled the trigger on making an acquisition outside its core inpatient rehab offering. HLS acquired Encompass, a provider of home health and hospice services in many of the same markets where HealthSouth provides inpatient rehab services. We think this deal will provide long-term strategic growth and market share benefits in the evolving healthcare landscape.

Our Worst 3 Stocks

Ticker	*Company*	*Description*	*Contribution (%)*
LL	**Lumber Liquidators**	do-it-yourself flooring company	-2.4
PODD	**Insulet**	diabetes pump manufacturer	-0.9
VRA	**Vera Bradley**	branded handbags and accessories	-0.7
		Worst	**-4.0%**

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 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.

Diabetes pump manufacturer **Insulet (PODD)** had a rough quarter, following a lot of excitement in late 2014. In September 2014, the longtime CEO was replaced by Patrick Sullivan, a healthcare veteran. In his last stint, Sullivan grew a small, single-product healthcare company into a dynamic multi-product company with more than $750 million in revenue before selling it.

The Street loves a winner, and the new CEO's vision for PODD was grand. Moreover, shortly after Sullivan was hired, the company resolved a reimbursement issue with a large health insurance company and revealed more details about its partnership with a large biotech company to use Insulet's Omnipod product for the delivery of biotech drugs. The Street was excited.

From the time of the announcement of the new CEO to year end, PODD stock was up nearly 40%. We trimmed our position on the exuberance, but we still believed in the long term story: pump use is underpenetrated in type 1 diabetics and the potential for using Omnipod in non-insulin delivery could be huge.

Unfortunately, as Sullivan got settled into his role he found the base business was not as strong as he or the Street thought. First, the fast growth in international sales was driven partly by overstocking at its international distributor. This could take a quarter or two to resolve.

Second, according to the new management team, what had been characterized by prior management as core diabetes pump revenue had also included revenue that was from lower-value, lower-margin ancillary products.

Sullivan also said that not enough marketing was done directly to the endocrinologist community, causing some erosion of Omnipod's mindshare.

On top of this, the diabetes pump business has just become more competitive, with some of the players being much larger, diverse healthcare companies with much more marketing muscle.

All of these issues came to light in January, and management's guidance for 2015 revenue was underwhelming. This sent the stock reeling, giving back all the gains since Sullivan was hired. The stock was down 27% in the first quarter 2015. This is an uphill battle for sure, but we are sticking with the stock.

Sullivan has hired seasoned marketing people to re-educate the physician community and he is much more engaged than his predecessor in partnering with other companies to fill some of the gaps in Insulet's offering. He also has very large goals for Insulet's non-insulin drug delivery business, which could be a huge boon. With the sell off to around $30, we see around $5 of downside in the stock. If Sullivan executes, the upside is $20 or more.

Handbag and accessories company **Vera Bradley (VRA)** shares fell markedly after a disappointing fourth quarter earnings report and lower-than-expected forward year guidance. We are impressed by new management's ability to quickly reposition the company and introduce new products. However, VRA is struggling to generate incremental purchases from existing customers and to drive traffic from new customers.

We are disappointed that the turnaround has not materialized faster, given positive feedback from new product launches, an improved marketing campaign to drive awareness on new products and many operational improvements. For this reason, we paid a visit to Fort Wayne, Indiana recently to get a feel for how difficult expanding the customer base will be. We expect a gradual build but have confidence that the brand is still relevant.

Best 3 Minus Worst 3 Stocks

	Contribution (%)
Best	2.3
Worst	-4.0
Best Minus Worst	-1.7
Rest of Portfolio	1.9
Total Daruma	0.2
Russell 2000	4.3
Return Difference	-4.1%

The net result of our winners and losers was a detraction from performance of 176 basis points. Lumber Liquidators made up 236 basis points of that decline. 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' 236 basis point hit. The rest of the portfolio was only able to generate 200 basis points of contribution. 14 stocks beat the Index, but were overshadowed by the 18 stocks that trailed.

Returns & Contribution to Performance by Sector

For the Russell 2000, biotech and pharmaceutical stocks powered the Healthcare sector, up 12.5%, leading the

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benchmark's performance during the quarter and adding 188 basis points to its 4.3% return. Materials & Processing followed at 5.3% and Technology came in third at 5.1%. Consumer Discretionary also clocked in with a 5% return, and these three sectors combined added 181 bps.

Consumer Staples and Financial Services returned 2%; Producer Durables, 1%, followed by Utilities at 0.9%, altogether adding 68 bps to benchmark performance. On the flip side, Energy, driven by the continued volatility in oil prices, was the only sector in the red and the Index's worst performer. It declined 2% but detracted just 6 bps from performance.

Daruma beat the Russell 2000 in only three sectors. Materials & Processing, up 9% vs. 5% for the benchmark, was led by A. Schulman, one of our best performing stocks in the quarter. Producer Durables was next (+8% vs. 1%) followed by Energy (+7% vs.-2%). Two of our Producer Durables stocks, professional staffing company On Assignment (ASGN), up 16%, and railroad equipment maker Wabtec (WAB), up 9%, were among our top ten winners, as was Carrizo Oil & Gas (CRZO), an Energy stock, up 19%.

The decent showing in these three was just barely enough to overcome our poor placement in Consumer Staples, (-10% vs. +2% for the Russell 2000), Consumer Discretionary (-5% vs. +5%) and Technology (-3% vs. +5%). We were overweight in Consumer Discretionary but lagged the benchmark returns by 10%, largely as a result of the decline in Lumber Liquidators.

Also overweight in Technology, we underperformed on a returns basis by 8%. It cost us 153 bps in relative performance. Being underweight Healthcare, combined with the fact that we own only one pharmaceutical stock, Pacira (PCRX), left us posting a paltry +0.4% return versus a +12.5% sector return; on a relative basis this meant we lost 170 bps of contribution.

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 3Q '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. 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.

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

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.

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. Please come visit us soon.

Snapshot of the Small-Cap Landscape

Ron Viener
Director of Trading

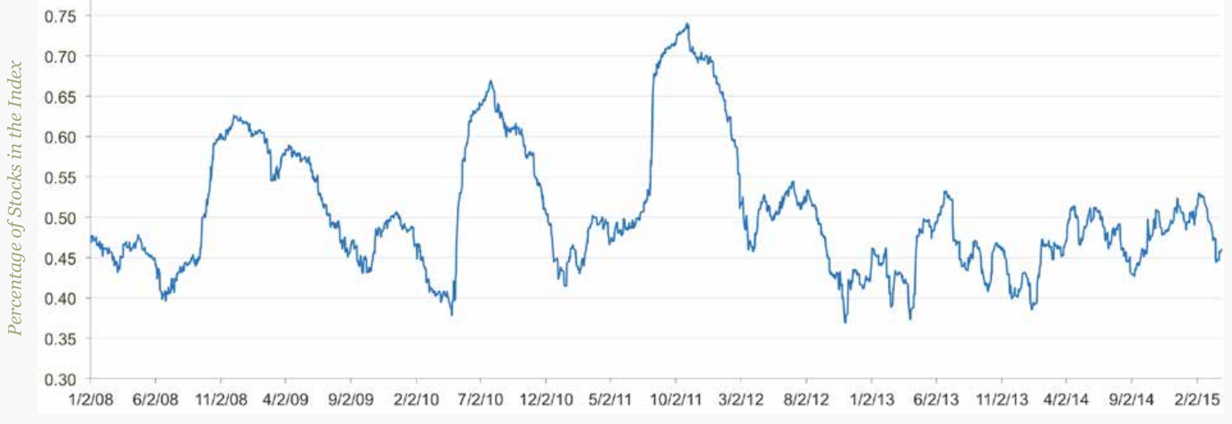
The first matrix on the following page (Exhibit 1) is the Russell 2000 sorted into deciles of performance according to different characteristics, some fundamental and some sentiment-based. The percentage in each box is the performance of that attribute (e.g. beta) for that decile. The second matrix (Exhibit 2) is for 2014 year-end results. The chart below (Exhibit 3) shows the correlation of the index' constituents to the Russell 2000 (average 60-day rolling correlation).

Many of the same trends that fueled 2014 performance continued for the Russell 2000 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 2000 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 2000 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	12.0	8.4	5.8	4.3	7.6	2.7	2.7	-0.9	-0.8	-16.4
P/E Ratio Lowest to highest[1]	-5.2	0.3	1.2	4.7	6.1	7.4	8.2	-	-	1.0
Dividend Yield Highest to lowest[2]	-2.0	2.4	3.3	5.3	4.1	-	-	-	-	2.7
Short Interest Lowest to highest	3.5	3.3	3.5	2.1	0.5	1.6	2.3	4.8	2.9	1.0
Beta Lowest to highest	1.8	4.4	4.6	3.9	3.5	2.8	2.7	2.1	0.3	-0.6
Sales Growth Best to worst	10.0	5.0	3.7	5.3	2.3	2.6	0.6	0.1	-4.0	-10.9
Analyst Ratings Best to worst	2.0	6.5	5.0	5.2	2.4	2.7	2.3	2.9	-1.9	-4.3
Institutional Ownership Most to least[3]	1.6	2.5	5.0	4.9	1.8	3.8	3.9	0.3	0.7	0.9
% Change in 2014 Best to worst[4]	7.0	4.6	5.0	3.8	2.6	1.2	2.4	1.4	-5.9	-5.1

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	30.2	13.6	11.2	12.6	7.9	1.1	6.8	3.0	-4.1	-31.5
P/E Ratio Lowest to highest[1]	-6.0	4.4	7.6	8.7	11.3	17.7	12.2	-	-	-2.0
Dividend Yield Highest to lowest[2]	1.8	8.5	6.5	8.8	-	-	-	-	-	4.4
Short Interest Lowest to highest	9.6	12.2	14.5	4.2	8.1	4.6	5.2	6.5	-0.1	-11.9
Beta Lowest to highest	13.8	13.2	10.2	10.0	3.0	2.3	2.7	-0.8	1.2	-2.9
Sales Growth Best to worst	13.1	14.9	2.6	6.1	8.3	10.5	4.8	5.2	-10.7	-18.3
Analyst Ratings Best to worst	7.4	17.0	18.1	6.0	8.2	1.6	1.3	1.0	-0.1	-6.7
Institutional Ownership Most to least[3]	1.6	6.1	7.1	2.7	11.2	7.4	7.9	2.5	4.4	1.6
% Change in 2014 Best to worst[4]	1.3	4.4	2.8	5.1	3.7	11.1	11.2	4.9	-3.4	-

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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