Second Quarter 2015

Small-Cap Portfolio Commentary

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It was close to the wire on the last day of the quarter, when we teetered on the brink of booking a positive absolute and relative quarter. Instead we ended the quarter down slightly at 6 basis points versus the Russell 2000, which was up 42 bps. We did exit the quarter on a high note though, up 2.93% for June versus 0.75% for the benchmark, outpacing the index by a solid 218 bps.

Our Best 3 Stocks

Ticker	Company	Description	Contribution (%)
TRAK	**Dealertrack**	software systems for auto dealers	2.1
TCBI	**Texas Capital**	Texas commercial bank	0.9
OXM	**Oxford Industries**	branded specialty apparel	0.5
		Best	**3.5%**

We had a good net contribution of 122 bps from the net of our top and bottom stocks. Our top 3 stocks generated 351 bps, thanks to automotive software developer Dealertrak (TRAK), up 211 bps; commercial bank Texas Capital Bancshares (TCBI), up 93 bps; and branded specialty apparel company Oxford Industries (OXM), up 47 bps. TRAK announced in June that it was going to be acquired by Cox Automotive at a 59% premium, TCBI enjoyed a shift in sentiment as investors expect a rise in rates in the near future, and OXM Industries delivered solid first quarter results as well as enjoying a wildly successful retail collaboration between its Lilly Pulitzer brand and Target.

Our Worst 3 Stocks

Ticker	Company	Description	Contribution (%)
VRA	**Vera Bradley**	branded handbags and accessories	-0.8
DGI	**Digitalglobe**	satellite equipment provider	-0.8
FRAN	**Francesca's Holdings**	apparel & accessories retailer	-0.7
		Worst	**-2.3%**

Our top three losers detracted 229 bps, driven by branded handbags and accessories maker Vera Bradley (VRA), down 82 bps; satellite equipment provider DigitalGlobe (DGI), down 76 bps; and apparel & accessories retailer Francesca's (FRAN), down 71 bps. All three are "show me" stocks, where their place in the portfolio hinges on reporting concrete progress in the second half of the year. VRA has made impressive operational improvements, but needs to show that it can attract new customers, which it plans to do with a new marketing campaign and new product introductions for the Fall. DGI needs to show growth in their commercial services division, as well as good sales of their higher priced, higher resolution imaging. We are heading out to the ESRI (Environmental Systems Research Institute) conference to speak to resellers and get a feel for what's going on in the satellite imagery market. Francesca's is showing glimmers of improvement in merchandising but is still suffering from weak mall traffic.

Rest of portfolio and sector performance

The rest of the portfolio still lagged however, detracting 128 bps in aggregate. This was frustrating, given that on a sector basis our returns were better than the Index sectors except for consumer discretionary and health care, shown in chart. We had three health care stocks clip us by 95 basis points this quarter, made worse by our zero exposure to biotech companies -- biotechs contributed 89 bps to the benchmark for the quarter. In contrast, our lack of exposure in utilities was a positive for us this quarter.

Financials were our best performing sector on both a returns and contribution basis this quarter, in contrast to the fourth quarter of 2014, when they were our worst on both counts. The irony is that our financial services holdings, TCBI and fleet payment processor WEX Inc. (WEX) were identical in both periods. We added to our TCBI position when the stock was weak and thus benefited when it rose 28% in the quarter.

Return by Sector for the Second Quarter (%)

Sector	Daruma Small-Cap	R2000	Variation
Financial Services	17.48	0.63	16.85
Producer Durables	4.26	-1.62	5.88
Utilities	0.00	-5.60	5.60
Energy	0.68	-2.66	3.34
Consumer Staples	1.06	-2.24	3.30
Materials & Processing	-2.92	-3.77	0.85
Technology	2.69	1.89	0.80
Consumer Discretionary	-10.23	-0.27	-9.96
Health Care	-4.99	5.69	-10.68

Source: Factset

Contribution by Sector for the Second Quarter (%)

Sector	Daruma Small-Cap	R2000	Variation
Financial Services	1.09	0.13	0.96
Producer Durables	0.69	-0.21	0.90
Technology	0.85	0.32	0.53
Utilities	0.00	-0.26	0.26
Energy	0.10	-0.10	0.20
Consumer Staples	0.02	-0.07	0.09
Materials & Processing	-0.31	-0.24	-0.07
Health Care	-0.66	0.92	-1.58
Consumer Discretionary	-1.84	-0.07	-1.77
Total	**-0.06**	**0.42**	**-0.48**

Source: Factset

Purchases and sales

We sold two positions in the quarter, transportation equipment maker Wabtec Corp. (WAB), which we first bought in 2002, and oil services company Tetra Technologies (TTI). WAB has the distinction of being the only stock in North America whose year-end stock price increased for 14 consecutive years. It has been a steady contributor for us over the years, but at close to $10B in market cap and sporting a rich valuation it was time to let it go.

TTI on the other hand, while making operational progress, is fighting the headwinds of lower energy prices, which led to massive price cutting and evaporating demand. Given the protracted downturn for energy, paying down debt quickly enough for comfort became problematic and we decided to move on.

We added three positions in this quarter, healthcare cost containment company HMS Holdings (HMSY), outdoor power equipment maker Briggs and Stratton (BGG) and logistics & LTL company Forward Air (FWRD). BGG is a classic value stock -- underfollowed and unloved, in part due to the timing volatility of earnings, which affected by weather. FWRD just acquired a competitor (CLP Towne Inc.) with a big geographic overlap who was also an aggressive price cutter. We believe the Street is underestimating the synergies and benefits that will result after the Towne acquisition is complete. The HMSY write up was included in last quarter's book given we bought it in early April.

Year to date performance

After the second quarter we remain behind the proverbial eight ball, up 0.18% vs. 4.75% for the Russell 2000, trailing by 457 bps. There are two big culprits for this underperformance -- DIY flooring company Lumber Liquidators (LL) and as previously mentioned, our zero exposure to biotech stocks. The former cost us 236 bps; the latter 176 bps. Early stage biotech stocks are not typical Daruma fare as outcomes tend to be binary, and they must constantly raise capital.

Our Best 3 Stocks Year to Date

Ticker	Company	Description	Contribution (%)
TRAK	**DealerTrack**	software systems for auto dealers	1.6
OXM	**Oxford Industries**	branded specialty apparel	1.5
HLS	**Healthsouth Corp**	impatient rehabilitation services	0.7
		Best	**3.8%**

In addition, and unlike the second quarter, the net of our top three and bottom three positions remains negative, costing us 1.28%. Our best three stocks contributed a total of 3.79%, led by Dealertrak (+161 bps), Oxford Industries (+145 bps) and inpatient rehabilitation services company Healthsouth Corp. (+73 bps). Oxford and Healthsouth were also winners in the first quarter.

Our Worst 3 Stocks Year to Date

Ticker	Company	Description	Contribution (%)
LL	**Lumber Liquidators**	do-it-yourself flooring company	-2.4
VRA	**Vera Bradley**	branded handbags & accessories	-1.5
PODD	**Insulet**	diabetes pump manufacturer	-1.2
		Worst	**-5.1%**

By contrast our bottom three detracted 5.07%, led by the first quarter's big loser, LL (-236 bps), VRA (-154 bps) and diabetes pump manufacturer Insulet (PODD), down 117 bps. We sold Lumber Liquidators in the first quarter. In hindsight, a quicker trigger finger would have softened the blow somewhat (though the decline was so sudden from the inflammatory 60 Minutes segment that we might have avoided only half the hit), but selling when we did saved us from another 56 bps of damage.

VRA and PODD were also first quarter losers, and continued to give ground this quarter. Vera (discussed previously) and Insulet are also "show me" stocks that need to deliver sales reacceleration to regain credibility with investors.

Insulet's new CEO has recruited a team of new talent, including those who have stewarded sales and marketing efforts very successfully at other medical product companies. PODD is focused today on doing as good a job reaching out to the medical community as it has been reaching out to diabetics, and on attracting other drugs to use its tubeless disposable pump as a dispensing vehicle. Despite the performance, we remain bullish on the prospects for the stock.

YTD rest of portfolio and sector performance

The rest of the portfolio contributed 146 bps, not nearly enough to offset the drag from our losers. For three months out of six, the rest of the portfolio beat the benchmark, but these beats weren't sufficient to overcome the months when it lagged. Over time 75% of our performance comes from the rest of the portfolio and only 25% comes from the net of our top 3/bottom 3. Every stock does indeed count in this portfolio.

On a returns basis we underperformed in four of the nine Russell sectors, laggards being health care and consumer discretionary. Insulet notwithstanding, most of our underperformance in health care was due to our zero weight in biotechnology stocks, which contributed 176 bps to the Russell 2000 year to date. Though consumer discretionary was also anemic for the Index, our lagging was stock specific and not due to any specific industry exposure.

Return by Sector Year to Date (%)

Sector	Daruma Small-Cap	R2000	Variation
Financial Services	15.82	2.41	13.41
Producer Durables	12.56	-0.40	12.96
Energy	7.40	-4.54	11.94
Utilities	0.00	-4.76	4.76
Materials & Processing	5.99	1.33	4.66
Technology	-0.14	7.12	-7.26
Consumer Staples	-9.46	-0.18	-9.28
Consumer Discretionary	-15.05	4.68	-19.73
Health Care	-4.61	18.85	-23.46

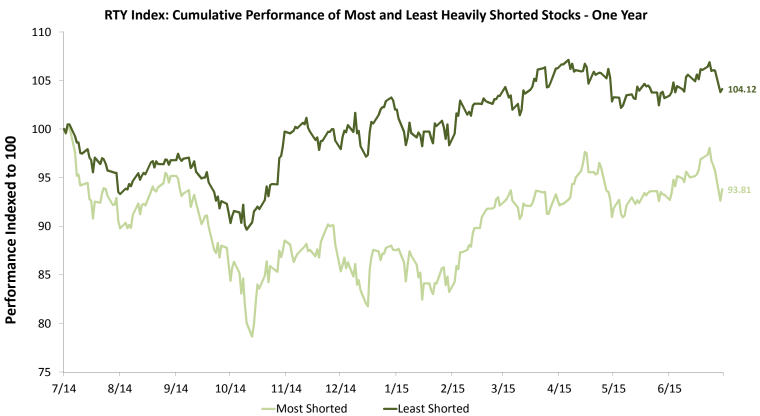
Source: Factset

Contribution by Sector Year to Date (%)

Sector	Daruma Small-Cap	R2000	Variation
Producer Durables	1.91	-0.06	1.97
Energy	0.40	-0.17	0.57
Materials & Processing	0.62	0.10	0.52
Financial Services	1.08	0.58	0.50
Utilities	0.00	-0.22	0.22
Consumer Staples	-0.27	-0.01	-0.26
Technology	0.06	1.07	-1.01
Health Care	-0.48	2.81	-3.29
Consumer Discretionary	-3.14	0.65	-3.79
Total	**0.18**	**4.75**	**-4.57**

Source: Factset

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



Market observations

As can be seen in the graph above, there has been rotation in the market between stocks that are heavily and not heavily shorted. Starting last year, stocks with the highest short interest started to underperform dramatically. This makes sense, if rates are expected to rise, that those companies that are either levered, or whose valuations are very affected by changes in discount rates, would fall out of favor.

Our portfolio, relative to the benchmark, has a bigger component of stocks that are shorted (more for being turnarounds than for being levered or early stage companies) relative to the Russell 2000. These circumstances have proved to be an unexpected headwind to performance. As you know, we don't overhaul the portfolio chasing short-lived trends, but we do assess short interest carefully in our positions.

Stop/loss is not the answer

Given the size of Lumber Liquidators' impact on the portfolio this year, we are sometimes asked whether having a stop loss in place would be helpful. After analyzing 20 years of data the answer is an emphatic no. Implementing a stop loss of 20% would have helped us by roughly 500 bps in 2014, but it also would have hurt us in 2013 by a similar amount[1]. Usually the effect is not as dramatic -- some years it would have helped a little, some years it would have hurt a little. Dealertrak is a prime example of a stock that was worth hanging on to, despite a big pull back last year. The Cox acquisition drove TRAK to all-time highs, well above 2014's peak.

Encouraging signs

Year to date we have bought four stocks and sold three, for an annualized turnover of 34%. Our five year annualized turnover average is 45% so our turnover is running lower than normal. I am pleased to note that going into earnings season we finally have some good new idea momentum. We are putting the finishing touches on some promising new ideas and have a handful that we have vetted and are waiting for better prices. Our pipeline is much, much healthier, which as you know is critical to our success.

In a concentrated portfolio new ideas are crucial to the health of the sell discipline, as they force out both expensive stocks (avoiding round tripping) and mistakes (capping further losses). Historically our alpha has been generated by our sell discipline, something I credit our 35 stock limit -- concentration makes discipline a lot easier to come by.

Nothing makes me happier than observing and generating new idea flow except working with talented colleagues who allow me to focus on the investment process. Martha Everett in client service and Dan Sendrowitz in compliance have been superb additions to the Daruma team. An introduction from each follows and their bios can be found in the appendix.

We are not unfamiliar with the magnitude of an extended duration of underperformance, which has happened at least three times in Daruma's history. Each time we bounced back with a vengeance, stock by stock, the meaningful lessons learned enabling us to make better mistakes tomorrow.

1. 20% was calculated relative to the sector performance

Notable Performers

Our Best Three

Company	Quarter End Position Size	Contribution
DealerTrack	3.1%	2.1%
Texas Capital Bancshares	4.1%	0.9%
Oxford Industries	3.2%	0.5%
Best		**3.5%**

DealerTrack (TRAK) – software systems for auto dealers
DealerTrack was our top performer in the second quarter (+59%) after the company announced plans to be acquired by Cox Automotive. DealerTrack's series of acquisitions, ongoing platform integrations and organic growth acceleration have positioned it as a disruptive force in auto retailing. While the market struggled at times to appreciate CEO Mark O'Neil's vision for the company, we have seen their platform evolve considerably since we purchased the shares in 2012. The stock has more than doubled in value during our 3-year holding period.

Texas Capital Bancshares (TCBI) – Texas commercial bank
TCBI is a bigger beneficiary of rising rates than investors are willing to give them credit for, given the expectation that the Fed will take action soon. Though its direct energy exposure is quite small, and though it has many national lines of business, because its commercial banking operations are in Texas, investors assume more sensitivity to energy prices than is warranted -- more stable energy markets lifted negative sentiment. TCBI should drive operating leverage and share gains from its continued ability to hire top talent from competitors. A new product launch is coming this quarter to add a new line of business for the bank. These catalysts should help TCBI shares continue to perform well.

Oxford Industries (OXM) – branded specialty apparel
Oxford Industries was a top performer for the second consecutive quarter. Solid first quarter sales trends continued for both Tommy Bahama and Lilly Pulitzer brands, and the company provided strong second quarter guidance. Lilly Pulitzer's comp sales growth of 20% was especially impressive, benefitting from a collaboration with Target that drove national brand awareness.

Our Worst Three

Company	Quarter End Position Size	Contribution
Vera Bradley	1.8%	-0.8%
DigitalGlobe	3.4%	-0.8%
Francesca's Holdings	2.2%	-0.7%
Worst		**-2.3%**

Vera Bradley (VRA) – branded handbags and accessories
Vera Bradley shares continued to underperform in the second quarter as earnings guidance fell below expectations. While the company has made clear progress on gross margin from improved inventory management and its made for outlet (MFO) strategy, sales trends weakened. New marketing initiatives in July (and a recently hired new Chief Marketing Officer), additional department store expansion and continued introduction of new product (which has met sales expectations) could go a long way to drive the shares in the back half of the year. At 11-12x EPS with $2.50 in cash per share and a clean balance sheet, the shares are trading at a defensive valuation.

DigitalGlobe (DGI) – satellite equipment provider
Shares of DGI performed poorly in 2Q as investors continue to wait for DGI to prove that it can accelerate growth in its commercial (non-US government) business. While management's outlook for the year was unchanged after their 1Q15 earnings report, their expectation for strong growth in the commercial segment became more back-half weighted. This resulted in more concern around making 2015 numbers, which was made worse by a rehashing of concerns surrounding government budget pressures and small satellite/drone imagery competition by short sellers. We continue to have confidence in DGI's ability to monetize new satellite capacity/capability from its new satellite WorldView-3 and the mid 2016 launch of WV-4. These new satellites should support our view of sustainable double digit growth in its commercial business and a significant increase in free cash flow as capital expenditures normalize.

Francesca's Holdings (FRAN) – apparel & accessories retailer
Specialty apparel company Francesca's shares sold off when the company provided below consensus second quarter guidance. While near term trends could be volatile, new CEO Michael Barnes has quickly taken steps to improve inventory management, redirect the e-commerce strategy and focus on store level sales training. Certain merchandising categories have shown signs of improvement (jewelry, gifts and dresses), and Barnes will lead a strategic review over the summer to set a course for better results. Barnes is known on the Street for his turnaround of Signet Jewelry where he did an excellent job creating a brand.

Second Quarter 2015

Snapshot of the Small-Cap Landscape

Ron Viener
Director of Trading

In these charts the Russell 2000 is 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.

That the second quarter was choppy can be seen in the mixed decile results. In contrast, what's worked vs. not worked in the market year to date follows a more linear progression.

In our monitoring of the Russell 2000 we've spotted a new trend: the outperformance of high p/e stocks as well as low (or no) dividend yielding companies. These characteristics are directly linked to the M&A fueled rally in biotechnology companies, an industry that has led the market higher. The outperformance of stocks that are least owned by institutional investors is also a new phenomenon, one caused by the second quarter rally in banks, an industry sensitive to the rise in interest rates and widely under owned by investors.

Furthermore, the top performing stocks are those that continue to trend higher, both first quarter winners and the best stocks of 2014, as well as the best-in-class sales growth companies. These metrics have been on our radar for a while now and continue to gain importance. Clearly the trend is still your friend and investors crave growth no matter the price.

Russell 2000 Performance (%) of Attributes by Decile as of June 30, 2015

Second Quarter

Deciles	1	2	3	4	5	6	7	8	9	10
Market Cap Largest to smallest	4.5	1.9	2.0	4.7	1.7	4.6	0.9	3.8	3.5	-2.6
P/E Ratio Lowest to highest[1]	-3.1	1.1	0.4	1.2	2.7	4.8	3.7	-	-	4.8
Dividend Yield Highest to lowest[2]	-5.0	0.1	4.6	2.0	9.5	-	-	-	-	4.2
Short Interest Lowest to highest	5.2	1.2	2.4	0.8	2.3	2.8	2.5	4.6	2.1	1.3
Beta Lowest to highest	4.6	1.8	0.9	0.8	2.6	0.8	5.5	2.0	2.9	3.3
Sales Growth Best to worst	6.7	6.6	3.2	3.5	1.1	-0.6	0.5	-2.2	-0.5	1.6
Analyst Ratings Best to worst	4.9	4.8	3.9	6.0	2.8	3.0	0.5	-1.9	0.0	0.5
Institutional Ownership Most to least[3]	0.4	-1.1	1.7	2.0	2.3	2.4	2.2	5.0	5.1	5.4
% Change Q1 2015 Best to worst	9.6	0.4	2.4	1.8	-0.3	2.8	1.4	2.9	0.6	3.5
% Change in 2014 Best to worst[4]	4.5	-2.4	-0.4	1.9	1.2	2.0	0.8	2.8	7.5	-

Year to Date

Deciles	1	2	3	4	5	6	7	8	9	10
Market Cap Largest to smallest	15.5	10.1	7.9	12.9	5.3	10.0	1.3	6.4	5.4	1.6
P/E Ratio Lowest to highest[1]	-4.9	2.3	3.3	5.8	10.8	11.5	7.1	-	-	13.4
Dividend Yield Highest to lowest[2]	-5.2	2.1	4.6	7.2	16.1	-	-	-	-	11.2
Short Interest Lowest to highest	14.5	4.5	7.2	5.1	2.3	8.6	5.8	14.3	5.9	2.5
Beta Lowest to highest	14.9	5.1	5.8	5.1	9.5	3.3	10.2	7.6	7.0	8.8
Sales Growth Best to worst	17.6	14.0	11.5	9.0	7.0	1.7	2.0	-3.6	-1.3	2.8
Analyst Ratings Best to worst	11.0	14.0	12.7	12.3	10.0	6.1	7.9	-1.7	0.5	3.7
Institutional Ownership Most to least[3]	3.1	4.0	4.0	5.9	8.1	6.5	8.5	7.3	13.2	16.9
% Change Q1 2015 Best to worst	65.3	20.3	14.3	8.9	3.1	3.3	-1.3	-4.2	-13.2	-26.3
% Change in 2014 Best to worst[4]	14.5	2.4	3.6	6.0	5.5	5.5	3.8	6.4	12.1	-

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 category is made up of all stocks that have no P/E.

2. Decile 10 of Dividend Yield category 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: CornerStone Macro & Daruma Capital Management

General Disclosures

It should be noted that this commentary should not be construed as an offer or a solicitation of an offer to buy interests/shares in any investment fund managed by Daruma. Any such offer will be made only to qualified investors by means of a confidential Private Offering Memorandum and other operative documents, and only in those jurisdictions where permitted by law. Neither the Securities and Exchange Commission nor any U.S. State or international securities administrator has passed on or endorsed the merits of any such offerings of these securities, nor is it intended that they will. Any representation to the contrary is a criminal offense. The firm does not offer or provide tax or legal advice. Individuals are urged to consult with their own tax or legal advisers before entering into any advisery contract.

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 2015 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. A list of the Top Ten holdings as of 06/30/15 is available on our website at http://www.darumanyc.com/portfolio/small-cap/.

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 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.

Several charts are included in the book to demonstrate certain information or conclusions. You should not make any investment decision relying only on these charts.

The information in this commentary is current as of the date of the commentary, unless otherwise noted, and may have changed by the time you read this. Daruma has obtained some of the information in this commentary from third-party sources we believe to be accurate. However, we cannot guarantee the accuracy of such information. Such third party information is footnoted.

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