First Quarter 2016

SMid-Cap Portfolio Commentary

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Founder, CEO & CIO

In the first quarter of 2016, our SMid-Cap composite outperformed the Russell 2500 by 448 basis points, up 4.87% vs. 0.39%. This marks two consecutive quarters and six consecutive months of outperformance. As a long-only manager, we are pleased to have delivered this type of consistency in a market that has been highly volatile on a month-over-month basis.

Returns for the quarter were broad-based. We had our best hit ratio since the inception of the SMid portfolio (April 2010). Over 74% of our stocks beat the benchmark, with 23 stocks positive for the quarter, of which 11 were up over 10%. The heart of the portfolio (i.e., the portfolio excluding the top and bottom three performers) contributed 444 basis points to performance. The net of our top three winners and losers generated 43 bps. This was not merely a good quarter — these were high quality results.

Top and Bottom Performers

Our top three stocks were Phillips-Van Heusen (PVH) +34.3%, Belden (BDC) +28.0%, and Microsemi (MSCC) +26.5%. These positions generated a total of 326 basis points, and all rose for stock specific reasons (better than expected fourth quarter results and/or increased guidance).

First Quarter top three contributors

Ticker	Company	Description	Contribution (%)
BDC	Belden	signal transmission equipment	1.33
PVH	Phillips-Van Heusen	global branded apparel	1.03
MSCC	Microsemi	semiconductor designer & supplier	0.90
		Total	3.26%

Our biggest detractors were Pacira Pharmaceuticals (PCRX) -30.9%, Scorpio Tankers (STNG) −25.6%, and Electronics for Imaging (EFII) -13.5%, costing us a total of 283 basis points. In two cases, sentiment was far more negative than fundamentals would dictate. Pacira, on the other hand, was dragged down by the biotech and pharma meltdown.

Scorpio was hurt by both weaker rates in refined petroleum transport (due to seasonality and refinery maintenance) as well as contagion from the market's reaction to abysmal rates for bulk and container ships, which are causing financial distress for other shippers.

First Quarter top three detractors

Ticker	Company	Description	Contribution (%)
PCRX	Pacira Pharmaceuticals	specialty pharmaceuticals	-1.52
STNG	Scorpio Tankers	refined petroleum transportation	-0.88
EFII	Electronics for Imaging	industrial printers and software	-0.43
		Total	-2.83%

First Quarter

	Contribution (%)
Best	3.26
Worst	-2.83
Best Minus Worst	0.43
Rest of Portfolio	-4.44
Total Daruma	4.87
Russell 2500	0.39
Return Difference	4.48

Electronics for Imaging Inc. (EFII) declined for stock specific reasons. To be precise, their fourth quarter report raised concerns that sales and margin targets would be harder to achieve going forward and we thought that this risk was not properly priced into the stock.

Purchases and Sales

We added four new positions in the quarter and sold one position.

Past performance is not a guarantee of future results. This information supplements the SMid-Cap Composite Presentation. The holdings identified do not represent all of the securities purchased, sold or recommended for clients. This should not be considered a recommendation to buy or sell any security.

Return by Sector for the First Quarter (%)

Sector	*Daruma*	*R2500*	*Variation*
Health Care	-2.42	-13.80	11.38
Technology	6.34	-1.54	7.88
Energy	3.06	-4.64	7.70
Materials & Processing	12.55	6.32	6.23
Consumer Discretionary	4.69	2.65	2.04
Producer Durables	2.41	4.89	-2.48
Financial Services	-3.48	0.30	-3.78
Consumer Staples	0.00	3.86	-3.86
Utilities	0.00	12.16	-12.16

Contribution by Sector for the First Quarter (%)

Sector	*Daruma*	*R2500*	*Variation*
Technology	2.21	-0.20	2.41
Materials & Processing	1.96	0.55	1.41
Health Care	-0.81	-2.08	1.27
Financial Services	0.23	-0.01	0.24
Consumer Discretionary	0.78	0.55	0.23
Energy	-0.03	-0.17	0.14
Consumer Staples	0.00	0.14	-0.14
Producer Durables	0.53	0.83	-0.30
Utilities	0.00	0.78	-0.78
Total	4.87	0.39	4.48

Source: FactSet

Leidos Holdings (LDOS) provides a broad range of technology services to the Department of Defense and other U.S. agencies, in addition to providing specialized services such as cybersecurity, electronic record keeping and advanced data analytics to health care and infrastructure companies. Leidos is acquiring a division of Lockheed Martin that offers complementary services and has many overlapping customers. The sales and cost synergies are large, and our feeling is that the stock price does not properly reflect this. Additionally, the deal structure (a reverse Morris Trust) is quite complicated and has not been well digested by the Street.

CoStar Group (CSGP) is a specialized technology provider that is often described as the "Bloomberg of commercial real estate." CoStar broadened its product offering to include apartment rentals, which have been growing at a better than expected pace, and the company has been investing heavily to support this growth. We own this stock in the Small-Cap portfolio and when we witnessed the market pullback in the first quarter, we saw an attractive buying opportunity for the SMid portfolio.

Microsemi (MSCC) is a specialty semiconductor company serving the aerospace, defense and communication industries. The company recently acquired PMC-Sierra, a leading global provider of semiconductor solutions. Integration of the two businesses is slated to result in a better product mix, an increased geographical footprint and greater customer diversification. MSCC has done a fine job over the years with acquisitions and integrations and has consistently delivered cost synergies, while meeting operational and financial targets.

Webster Financial (WBS) is a financially sound, well-run bank in the CT/NY/New England region. In addition to their banking franchise, WBS owns HSA Bank, the dominant provider of Health Savings Accounts (HSAs). The rapidly growing HSA market continues to bolster HSA Bank's standing as a valuable asset for WBS. The bank has captured a significant market share and also serves as a solid cash flow generator for WBS. At current price levels, we feel that the market is not appropriately valuing the upside of the HSA business.

We sold Electronics for Imaging Inc. (EFII) on concerns that the company would struggle to deliver the necessary organic and acquisition growth needed to support its valuation and that margins would stop expanding.

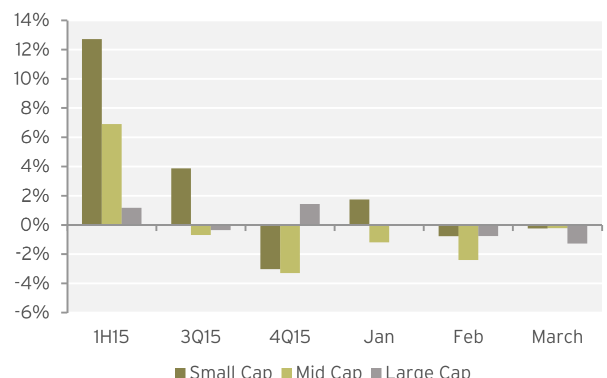
Market Commentary

The once darling momentum stocks have finally fallen out of favor. In a late cycle market, breadth narrows and fewer and fewer stocks work. One by one, momentum stocks get knocked off the pedestal as valuations become hypersensitive to the first whiff of fear or disappointment. This trend toward favoring valuation over momentum began in the late summer 2015 and was exacerbated by the meltdown in biotech and specialty pharma in the first quarter. Add in the flare ups on the global macro and political fronts, and the roller coaster ride became even more pronounced. To paraphrase the reality TV show *Project Runway*, it was a market in which "one day you're in, the next day you're out."

The relative total returns of the most crowded names in long-only, actively managed small-cap funds were at ridiculously high levels for most of 2015 (see chart 1). This trend reversed sharply in February of 2016. The most crowded names sold off, and the unloved stocks (e.g. last year's underperformers or those with the lowest analyst ratings) led the way. Headwinds lifted as the dollar weakened, and value names that were shunned because of their international exposure began to recover (e.g., industrials and basic materials). Investment grade companies no longer ruled the roost as excessive fears over leverage and global macro conditions abated.

It is unusual to see as pronounced a market regime change as the one we are now seeing. After a staggeringly long run for growth stocks, the market has finally changed its tune. The monthly spread between growth and value stocks peaked at the end of December, marking an inflection point and heralding a return to value. This latest growth cycle in the Russell 3000 (a broad market benchmark) lasted 114 months, which is the longest run on record since its inception in 1979.

Recent Darlings Performance vs. Benchmark
Total Returns, Relative to Respective Benchmarks



Source: Credit Suisse

During this cycle, the Russell 3000 growth index beat the value index by 65.9%. Although this is less than the 175.8% return of growth relative to value that we saw in the elation of the 2000 tech bubble, it is far greater than the cycles ending in 1980 and 1991, which generated 34.5% and 53% respectively. There is no question that growth is sexy, but a rotation to value can be lucrative. The value cycles ending in 1988, 1993, and 2006 delivered 123.3%, 31.2% and 109.8% in relative returns, respectively. If history is any guide, a value rotation is a real source of upside and should not be taken lightly.*

The market, however, is not cheap. While the S&P 500 is at 1.3 standard deviations above its 30-year average (down only slightly from its 1.5 high in early 2015), these levels are tough to maintain. At a standard deviation of 1.5, valuation was above pre-financial crisis highs but below tech bubble highs.*

On a relative basis (to the S&P 500), the Russell 2000 is -1.11 standard deviations below its 30-year average, or just off its 1990 low. On an absolute level, current valuations are .58 standard deviations above the Russell 2000's 30-year average. In short, although the small-cap market is not cheap by historical measures, it is currently valued far more attractively than the large cap universe.*

As a long-only manager, typically we are at least 90% invested at all times so regardless of the environment, we continue to look for stocks whose prospects are misunderstood or mispriced by the street. Small-cap and smid-cap companies are dynamic, nimble, and able to grow or change rapidly. They are also underfollowed which means that fundamental stock pickers who dig deeply into the details can have a competitive advantage. Although valuations are a bit on the high side today, in any market environment we aim to find 25 to 35 stocks with the capacity to beat the benchmark. This helps us to stay focused and disciplined in our approach and process.

**Source: Credit Suisse: " March in a Nutshell" by Lori Calvasina, April 4, 2016.*

Noteworthy Positions

Our Best Three Contributors

Company	Quarter End Position Size	Contribution
Belden	4.1%	1.33%
Phillips-Van Heusen	3.1%	1.03%
Microsemi Corporation	3.6%	0.90%
Total of Best Three		**3.26%**

Belden (BDC) – signal transmission equipment
During its December investor day, Belden management reduced expectations, taking 2016 revenue guidance down due to a slowdown its industrial division. The stock sold off into the end of the year and then sold off again with the rest of the market during January. Belden's price was impacted twice by the same macroeconomic fear, at which point the stock was just too cheap. We worked through a few scenarios and determined that even after stress testing the company's 2016 results, we still had an opportunity to add to the position at a 10% free cash flow yield. In our opinion, the stock was discounting financial Armageddon. We bought shares below $40. Following the announcement of 4Q results and 2016 guidance (that was in line with previous statements) the stock recovered and has continued to trade higher.

Phillips-Van Heusen (PVH) – global branded apparel
Market sentiment was so negative around retail and apparel in the back half of 2015 that expectations for fourth quarter results were very pessimistic. As the stock drifted to new lows in January we felt that sentiment was overdone, and we added to the position. Fourth quarter results surprised positively, with better than guided EPS results and better results from the Calvin Klein brand. After acquiring Calvin Klein from Warnaco, PVH has been reinvesting in the brand, which is beginning to pay off. Calvin Klein sales were up 21% (constant currency) and same store sales were up mid-single digits.

Microsemi Corporation (MSCC) – semiconductor designer & supplier
We initiated our position in MSCC as it was hitting lows in January. We recognized the potential in the PMC-Sierra (PMCS) acquisition and viewed MSCC as well positioned in the areas of semi-conductors with better secular growth drivers. When MSCC reported a strong 1Q, it also gave indications that the PMCS integration was going well, and gave a constructive guide on FCF generation for the year. The stock rose further mid-March following the announcement of the divestiture of low-margin businesses.

Our Worst Three Detractors

Company	Quarter End Position Size	Contribution
Pacira Pharmaceuticals	3.0%	-1.52%
Scorpio Tankers	2.1%	-0.88%
Electronics for Imaging	0.0%	-0.43%
Total of Worst Three		**-2.83%**

Pacira Pharmaceuticals (PCRX) – specialty pharmaceuticals
There was no escaping the beating taken by the pharma and biotech sector this quarter. PCRX stock was down 31% for the quarter, along with biotech stocks down 27% and pharma stocks down 32%. There really wasn't much company specific news that drove the stock's weakness. Rather, in our view, coming off of a monster fourth quarter of 2015 (up 86%), PCRX was an easy company to take profits from or to otherwise sell in this anti-drug company investment environment. But we still like the PCRX story. We believe that Exparel sales will reaccelerate in the second half of 2016, as the company publishes more data about the patient outcome benefits and hospital economic benefits of Exparel.

Scorpio Tankers (STNG) – refined petroleum transportation
It was a rough quarter for STNG. Demand for product tankers is increasing, and spot rates have increased significantly since we bought the stock. And, with the supply of new product tankers hitting the market dropping significantly in early 2017, we believe the supply/demand dynamic will continue to support strong spot rates. However, the stock continues to be weak, largely in sympathy with, though to a greater magnitude than, the energy sector. STNG was down 26% for the quarter versus the energy sector down 5%. The Energy sector staged a solid comeback in March…STNG did not participate. This has been frustrating for sure, but we have faith that fundamentals will eventually carry the day. Spot rates are strong and if they stay at these levels, STNG is likely to generate nearly $2 per share of annual free cash flow beginning in 2017. Even if half of this goes to pay down debt each year, it leaves $1 per share of annual cash flow. With STNG stock trading at under six times that, we believe the stock is very undervalued.

Electronics for Imaging (EFII) – industrial printers and software
We decided to sell out of our position in EFII at the end of January, after our analysis showed that the potential upside in the stock didn't justify the risks. We believe that EFII may find it challenging to maintain growth rates while expanding margins, since the newer businesses EFII had entered were margin dilutive and the accretive software business was limited by the shrinking pool of potential acquisitions.

Snapshot of the SMid-Cap Landscape

Ron Viener
Director of Research

First quarter 2016 can be summarized in one word: Reversal

Suddenly what had been working stopped working. Stocks that previously provided the best returns in both the fourth quarter and the full year 2015 were pounded hard. Investors in smid-cap punished companies with the highest p/e ratios, lowest dividend yields, highest short interest stocks, or high beta. The breakdown in biotech stocks fueled the reversal as these companies littered the bottom decile of returns.

By contrast, financial stocks were a safe haven for investors during this volatile quarter. Investors preferred larger market cap and lower beta companies, as returns on both these characteristics progressed almost linearly and financials were overrepresented in the best performing deciles.

Russell 2500 Performance (%) of Attributes by Decile

In these charts, the Russell 2500 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.

First Quarter 2016

	1	2	3	4	5	6	7	8	9	10
Market Cap Largest to smallest	3.9	4.6	2.1	2.4	-1.1	-0.8	-3.3	-3.8	-7.2	-18.6
P/E Ratio Lowest to highest[1]	-7.7	-2.4	0.4	3.9	5.3	5.1	3.6	2.3	-	-12.5
Dividend Yield Highest to lowest[2]	2.2	2.9	3.5	3.8	4.6	-	-	-	-	-6.8
Short Interest Lowest to highest	2.1	2.7	0.5	0.9	-1.6	-3.1	-2.6	-5.6	-8.2	-6.9
Beta Lowest to highest	6.4	2.0	0.4	-0.6	-1.3	-0.8	-4.2	-4.0	-9.8	-10.1
Sales Growth Best to worst	-10.6	-3.9	0.6	0.4	1.6	1.6	3.7	0.7	-0.9	-9.2
Analyst Ratings Best to worst	-7.3	-8.5	-4.6	-1.8	-1.2	-2.4	0.2	3.1	2.8	-3.2
Institutional Ownership Most to least[3]	-0.7	-1.8	-0.6	-1.4	-2.5	-1.2	-2.7	-3.7	-4.9	-2.4
% Change in Q4 2015 Best to worst	-11.2	-3.5	-0.7	0.5	-0.6	-0.9	-0.7	-0.1	-3.4	-0.2
% Change in 2015 Best to worst[4]	-9.3	-3.9	-2.9	-0.0	-0.2	0.5	0.4	1.3	-2.9	-1.0

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 2015 is made up of stocks with no complete 2015 performance.

Sources: CornerStone Macro & Daruma Capital Management

General Disclosures

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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 12/31/15 is available on our website at http://www.darumanyc.com/portfolio/smid-cap/.

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.

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.

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