DaRUMa

Where Every Stock Counts®

FIRST QUARTER 2018

PERFORMANCE COMMENTARY

SMALL-CAP COMPOSITE

1ST QTR PERFORMANCE

	Contribution (%)
Best	2.09%
Worst	-2.40%
Best Minus Worst	-0.31%
Rest of Portfolio	-1.49%
Total Daruma	-1.80%
Russell 2000	-0.08%
Return Difference	-1.72%

Dear Client and Friends,

Our mantra in 2018 is “Simplicity and Focus”. To that end, we redesigned our quarterly report to present all the essential information needed for a full understanding of performance in a format that’s much easier to digest. Please let us know what you think!

The Daruma Small-Cap composite was down -1.80% vs. a relatively flat market (-.08% for the Russell 2000) and we trailed the Index by 172 bps. While 57% of the portfolio (by weight) beat the Index in the quarter, this did not provide enough lift to offset the drag of the laggards.

In 30 years of investing, this has been one of the most frustrating markets in which I have operated. In this increasingly fragmented, short-term world where the conversation is dominated by algorithms and aggressively deployed passive products, valuations fluctuate on the news of the day and we experience short cycle oscillations between what’s working and what’s not. In a market where rapid ebbs and flows are causing violent cross-currents, the subtleties of portfolio composition make all the difference. We are frustrated with our Small-Cap performance and this is exacerbated by the fact that our SMid-Cap portfolio (which is run in exactly the same manner) continues to do well.

2018 began with a continuation of 2017, i.e. a relentless march upwards, with low volatility and ever expanding multiples, goosed by tax reform. The bulk of our underper-

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formance occurred in January when the combination of a sharp market upturn and disappointing fundamental news on several of our stocks caused 141 bps of relative underperformance and we spent the rest of the quarter trying to close the gap. This upward trend softened in February and March and we view the rest of the quarter's market gyrations (and increased intraday volatility) and our own relative intraday volatility as an encouraging sign. Just as the ice pack begins to break up and melt in spring, we are finally seeing low volatility and a breakdown of 2017's implacable momentum, and this bodes well for stock pickers such as ourselves and conditions may well be positioned to turn in our favor.

Details on winners and losers, sectors of note and market observations follow.

As always, we are happy to discuss our first quarter results with you.

All the best,

Mariko

Mariko O. Gordon, CFA
Founder & CEO

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1ST QUARTER 2018

WINNERS AND LOSERS

SMALL-CAP COMPOSITE COMMENTARY

Top Contributors

Company	Quarter End Position Size	Contribution
PROS Holdings, Inc.	3.9%	0.77%
CoStar Group, Inc.	3.8%	0.73%
Callaway Golf Company	4.0%	0.59%
Total		**2.09%**

PROS HOLDINGS

Pricing optimization software provider

+77 bps

COSTAR GROUP

Real estate services provider

+73 bps

CALLAWAY GOLF COMPANY

Golf equipment and apparel maker

+59 bps

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Our best three stocks contributed a total of 209 basis points but this was offset by our worst detractors, which cost us 240 bps, for a net negative of 31 bps. We normally have a positive net, so this is disappointing, and the rest of the portfolio did not generate enough performance to offset the difference.

While our big winners are companies in completely different industries with very different business models, they have one thing in common – their fourth quarter results all exceeded the market's expectations. The outlook on these stocks remains positive for 2018.

For PROS Holdings (PRO), this is an inflection point year in the business model transition from enterprise to software as a service and the company is also benefiting from a slew of new products and thriving partnerships with Microsoft's Azure, among others.

CoStar Group (CSGP) continues to grow its apartment rental listings and marketing offering and is reaping the benefits of upselling to customers acquired when it bought Loopnet. CoStar also has a formidable competitive moat which gives it considerable control over its fate.

Callaway Golf Company (ELY) continues to gain market share as well and is successfully executing on its plan to expand margins.

Although Pacira Pharmaceuticals (PCRX) has more consistently reported good monthly sales growth of late for its flagship non-opioid surgical analgesic, a contentious and negative FDA adcom panel vote on expanding usage for upper extremity surgeries hit the stock hard. After quarter-end however, the FDA approved the expanded label, and the stock is up about 20%. We have weathered many storms with Pacira but we believe in their product and expect the partnership with Johnson and Johnson to continue to accelerate sales growth.

1ST QUARTER 2018

WINNERS AND LOSERS

SMALL-CAP COMPOSITE COMMENTARY

Top Detractors

Company	Quarter End Position Size	Contribution
Pacira Pharmaceuticals, Inc.	2.3%	-1.06%
EnPro Industries, Inc.	3.4%	-0.72%
Beacon Roofing Supply, Inc.	3.1%	-0.62%
Total		**-2.40%**

PACIRA

Specialty pharmaceutical maker

-106 bps

ENPRO INDUSTRIES

Gasket, sealant and engine maker

-72 bps

BEACON ROOFING SUPPLY

Distributor

-62 bps

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EnPro Industries (NPO) was weak as shareholders who were playing for the reconsolidation of the Garlock subsidiary (and the completion of the asbestos claim issues) exited the market. Additionally, 2018 guidance appeared weak on the surface, which also hurt the stock. We bought NPO for the combination of reconsolidation (we reaped the benefits of this) and the prospects for the business going forward. We are still believers. The story behind the 2018 guidance is complex and on deeper analysis, when guidance is adjusted for the F/X benefit booked in the 4Q of 2017 for a large power systems contract in France, EBITDA growth is actually expected to grow 5 to 7% on revenue growth of 3 to 5% in 2018 and this news is positive. We continue to feel that EnPro's future growth can accelerate with significant new product introductions in the aerospace and power generation markets.

Beacon Roofing (BECN) was weak after reporting a fourth quarter that showed some gross margin compression. Asphalt shingle manufacturers are continuing to raise prices and investors are worried that Beacon will not be able to pass the price increases on to customers. In addition BECN closed on a large acquisition (Allied Building Products) in January that levered its balance sheet. The Street is more wary of increased leverage now that rates are rising. We monitor leverage as well but we have a long history with Beacon, and know that they are good integrators as well as operators, so we are less concerned on this count and expect them to de-lever post acquisition, as they have with other acquisitions in the past. We expect that debt pay down will be a priority, and that BECN will also be able to pass along price increases and show a recovery in margins as the year progresses.

1ST QUARTER 2018

SECTORS OF NOTE

SMALL-CAP COMPOSITE COMMENTARY

The best performing sectors in the market were Health Care and Technology. Health Care was up +6.5%, broadly based across most industry groups, a welcome change from having the Biotech tail wag the Health Care dog in quarters past. Technology was up +6%, largely due to software stocks.

The worst sectors were Energy (down -9.9%) and, curiously, the defensive sectors of Utilities (down -5.1%) and Consumer Staples (down -7%). We continue to see a big disconnect between the performance of the Energy sector (down) and the price of crude (steady to increasing). This gap became especially pronounced in the 2H of 2017 and is now at a peak. While Utilities and Staples were down for the quarter, they exited the quarter on an upswing with strong breadth as investors took a more defensive posture. This wasn't enough to make up for being left in the dust in January, however.

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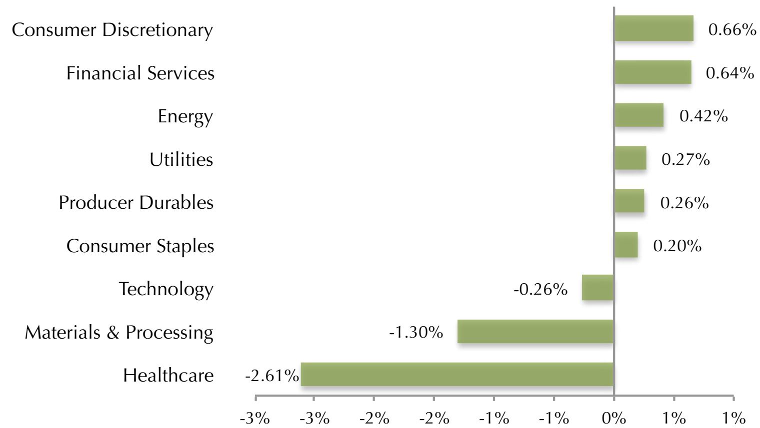
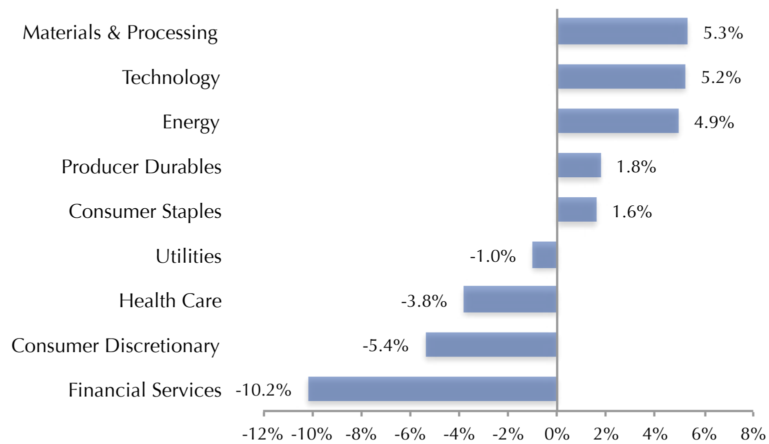
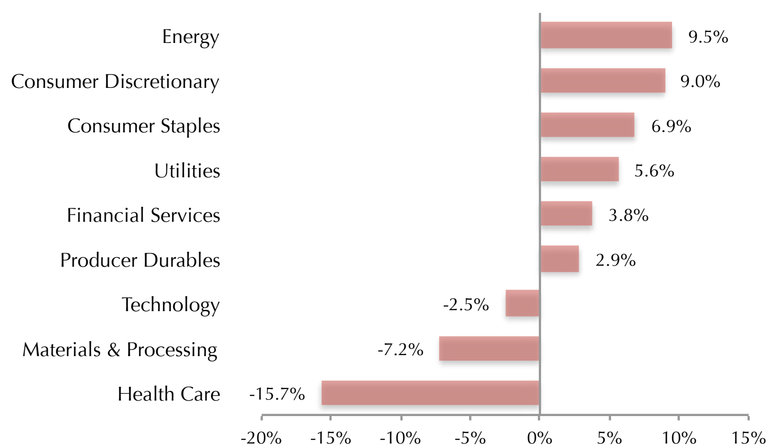
CONTRIBUTION DIFFERENCE DARUMA VS. R2000



DARUMA SECTOR OVER/UNDERWEIGHT VS. R2000



RETURNS DIFFERENCE DARUMA VS. R2000



Sources: FactSet, Russell Investments & Daruma Capital Management

1ST QUARTER 2018

MARKET OBSERVATIONS SMALL-CAP COMPOSITE COMMENTARY

This market is rife with cross currents as the prolonged earnings growth associated with late cycle markets becomes interwoven with rising rates, inflation fears and the beginnings of multiple compression. This plus the newfound weakness in the FAANG stocks suggests that we have a long in the tooth market that is primed for a "risk off" scenario and a potential change in investor mindset. Specifically, investors should begin paying more attention to the differences between individual stocks as well as focusing more on balance sheet strength, quality, and overall stability. In fact, as the quarter progressed it was notable that even on up days, the more defensive stocks lead the market.

In general, performance characteristics of the Russell 2000 supported this risk off mindset. The largest stocks continued to beat the smallest stocks by a huge margin (+6.2% vs. -14.8%) and the lowest beta companies trounced those with the highest beta, (+3.9% vs. -3.8%). Growth was also rewarded, with the best top line growers up +6.1% vs. -8.3% for the worst. See table below.

The divergence between the S&P 500 and the Russell 2000 was notable in the quarter. While the year got off to a great start with the Russell up +2.6% in January, it lagged the S&P 500, which was up a phenomenal +5.6% for the month. February reversed hard, with the R2000 down -3.9%, matching the S&P 500 exactly. In March however, the Russell was up +1.3% while the S&P 500 was down -2.5% signaling a breakdown in large-cap leadership that bodes well for small-cap investors. Additionally, although small-cap stocks are near absolute valuation highs, they are at the 38th percentile relative to large-caps and still remain attractive on a comparative basis.[1]

We welcome the volatility that demands discernment from investors and we are watching the "hot money" ETF flows closely. These "invisible hands" that can be so disruptive in the short-term can be good contrarian signals that show us where to fish for opportunities. The data on the behavior of hot ETFs are highly compelling – their investors "buy high and sell low" and areas with the biggest inflows go on to underperform, while those with the biggest outflows go on to do better than the market.

We believe that in the coming months active management should start to pay off. While we can debate how fast and how high rates will rise, we know that the era of continuous decline in rates is over -- this means that balance sheets matter once again, and that investors will once again care about cash flows.

WHAT DROVE THE RUSSELL 2000?

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.

	1Q 2018									
Deciles	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Market Cap (Largest to Smallest)	6.2%	1.4%	0.8%	0.6%	1.6%	3.6%	0.1%	-1.3%	-3.5%	-14.8%
P/E Ratio (Lowest to Highest)*	-3.6%	-3.5%	-0.8%	1.7%	1.5%	0.3%	1.9%	1.8%	-0.3%	-2.6%
Dividend Yield (Highest to Lowest)**	-8.8%	-2.4%	-0.2%	0.8%	4.6%	-	-	-	-	0.7%
Short Interest (Lowest to Highest)	1.1%	1.4%	-1.0%	-0.7%	-1.6%	-1.2%	0.0%	-1.0%	-1.4%	-0.9%
Beta (Lowest to Highest)	3.9%	-2.2%	0.1%	0.4%	-0.4%	0.3%	-3.1%	0.2%	-0.6%	-3.8%
Sales Growth (Best to Worst)	6.1%	1.3%	0.6%	0.7%	0.7%	0.0%	-0.5%	-3.5%	-6.8%	-8.3%
Analyst Ratings (Best to Worst)	-0.1%	7.2%	1.3%	2.1%	-1.2%	-0.8%	-0.5%	-3.0%	-5.8%	-10.1%
Institutional Ownership (Most to Least)***(*)	2.3%	-1.0%	0.0%	-0.3%	-2.4%	1.2%	-1.1%	-3.8%	2.2%	-2.4%
% Chg Q4 2017 (Best to Worst)^	-3.5%	2.3%	-2.3%	-0.6%	-0.4%	-0.7%	-1.5%	-1.7%	2.1%	-1.3%
% Chg in 2017 (Best to Worst)^^	0.1%	0.9%	2.2%	0.8%	-0.8%	0.4%	0.0%	-3.7%	-2.7%	-5.1%

*Decile 10 of P/E Ratio category is made up of all stocks that have no P/E
**Decile 10 of Dividend Yield category is made up of all stocks that pay no dividend
***Institutional Ownership may be over/under stated due to timing of filings
****Institutional Ownership is as of the end of last quarter (if report completed intra-quarter)
^% Change in Q4 2017 excludes stocks without complete performance
^^% Change in 2017 excludes stocks without complete performance

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

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

Sources: Bloomberg, Russell Investments & Daruma Capital Management

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1. DeSanctis. Steven G, CFA "US Equity Strategy Note", Jeffries, April 4, 2018

1ST QUARTER 2018
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A list of the Top Ten holdings by portfolio weight as of 03/31/18 is available on our website at http://www.darumanyc.com/portfolio/small-cap. These holdings and certain other performance information contained in this presentation supplement the Small-Cap Composite Presentation, which is available on our website at https://www.darumanyc.com/disclosures/equity-composite-presentation-small-cap.

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The appropriate comparison benchmark for the Small-Cap Equity strategy is the Russell 2000. The Russell 2000 includes approximately 2000 of the smallest U.S. common stocks based on a combination of their market cap and current membership in the Russell 3000. The Russell 2000 Value Index includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values, while the Russell 2000 Growth Index includes those with higher price-to-value ratios and higher forecasted growth values.

The Small-Cap Equity strategy is a concentrated strategy that is not managed to a benchmark, so there are material differences in characteristics, such as the number of holdings and sector and industry weightings. In addition, benchmark performance does not include any fees or expenses. Because of these differences, benchmarks should not be considered a completely accurate comparison.

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