Daruma

Where Every Stock Counts®

SECOND QUARTER 2018

PERFORMANCE COMMENTARY

SMALL-CAP COMPOSITE

2ND QTR PERFORMANCE

	Contribution (%)
Best	2.34%
Worst	-1.58%
Best Minus Worst	0.76%
Rest of Portfolio	4.68%
Total Daruma	5.44%
Russell 2000	7.75%
Return Difference	-2.31%

Dear Client and Friends,

For 2Q 2018, Daruma's Small-Cap Composite was up +5.44% vs. +7.75% for the Russell 2000, lagging the Index by 231 bps.

The second quarter started off with a bang — we had a terrific April (+2.47% vs. +0.86% for the Index) which nearly brought us in line with the Russell 2000 for the year. This truly demonstrates the advantage of a concentrated portfolio — when conditions reverse, performance can change abruptly and materially. April's market was notable for the odd bedfellows of market drivers — the Energy sector was strong (+13.4%) and contrary to what might be expected, defensive sectors such as Utilities (+4.3%) and Staples (+2.7%) were strong as well. Unfortunately, this didn't last and when the market ripped in May (R2000 up +6.07%) it outstripped our otherwise respectable +3.08% for the month. May's market strength was broad based across sectors, but the standouts were Health Care and Technology. In June we were down -17 bps, while the Russell 2000 was up +72 bps as the market showed a rotation to more defensive sectors (Utilities and Staples) and escalating trade war rhetoric brought about a more domestic focus and drove up the Consumer Discretionary sector. At the close of the second quarter, we are up +3.54% year to date vs. 7.66% for the Russell 2000, lagging by 412 bps.

While we remain pleased with the long term prospects for our holdings, we must continue to navigate the short term cross currents that bedevil this market environment. Although we can and should do better, we take some small comfort in that we are not the only ones suffering: only

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2ND QUARTER 2018

PERFORMANCE COMMENTARY

SMALL-CAP COMPOSITE

14.1% of small-cap managers are beating the Benchmark year to date and only 16.7% are beating the Benchmark in the second quarter. The average core fund trailed by 200 bps in 2Q and by 300 bps year to date.[1]

For the second quarter, the best performing sectors were Consumer Staples (+14.2%) and REITs (+13.0%) — both more defensive plays, as well as Energy (+20.5%) which, while economically sensitive, marches to its own drummer and is impacted by many exogenous global factors. Year to date, the best performing sectors by far (and the only two with double digit returns) are Health Care at +17.2% and Technology at +13.2%. In short, the turn towards defensive stocks in the second quarter was not enough to topple growth from its year to date pedestal. With 10-year rates down in the quarter, Financials lagged, while Utilities and Real Estate stocks performed well.[2]

Of particular note, were the massive inflows of $9.5 billion into small-cap ETFs in the second quarter. Fear of a stronger U.S. dollar (up 8% from its February low) and tariff saber rattling led investors to chase small-caps in the belief that they have less international exposure. As ETF flows are blind to the realities of individual company valuations, high P/E stocks and non-earners performed well in 2Q and year to date, which hurt the ability of fundamental stock picking to deliver outperformance. From an overall valuation perspective, it is interesting to note that the rolling 12 month spread between the first and fifth quintiles in Free Cash Flow Yield is quite wide, and is nearing levels last seen at the end of 1999, 2002 and 2003 (all periods that marked inflection points in the markets).[3]

The influx of capital into small-cap ETFs also drove the outperformance of low-priced stocks (+9.5% vs. +7.1%) while the desire to avoid international currency and tariff woes drove stocks with low foreign sales (<20%) to outperform

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[1]DeSanctis. Steven G, CFA “U.S. Equity Strategy JEF’s SMID-Cap Manager Scorecard Q2 was not pretty for active managers”, Jefferies, July 1, 2018
[2,3]DeSanctis. Steven G, CFA, “U.S. Equity Strategy JEF’s SMID-Cap Q2 Recap Slides & 2H Outlook - Tough Sledding for Active Mgrs”, Jefferies, July 6, 2018

those with high foreign sales exposure (+8.5% vs. +6.3%). Additionally, continued tightening by the Fed caused investors to avoid stocks with levered balance sheets and stocks with the lowest leverage are beating those with high leverage for the quarter (+9.1% vs. +6.7%) and year to date (+11.1% vs.+4.9%).[4]

This is not a healthy market — it feels thin and stretched, and it's hard to make a case for either multiple or margin expansion. Big price moves are happening on low volume. April was encouraging, but this wasn't enough to turn around performance in our Small-Cap portfolio and that remains our primary goal. As always, we are looking for attractive new ideas and, while we've been frustrated when intriguing ideas move sharply away from us on a little volume, we are determined to stay patient and we don't want to chase stocks. Rather, in this fickle and punishing market, we are following a number of potential opportunities closely and stand ready to add compelling long term investments when we see attractive entry points.

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

All the best,

Mariko

Mariko O. Gordon, CFA
Founder & CEO

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[4]DeSanctis. Steven G, CFA, "U.S. Equity Strategy JEF's SMID-Cap Q2 Recap Slides & 2H Outlook - Tough Sledding for Active Mgrs", Jefferies, July 6, 2018

2ND QUARTER 2018

WINNERS AND LOSERS

SMALL-CAP COMPOSITE COMMENTARY

Top Contributors

Company	Quarter End Position Size	Contribution
WEX Inc.	4.5%	0.79%
Evercore Inc.	4.1%	0.79%
Encompass Health Corporation	4.9%	0.76%
Total		**2.34%**

WEX
Payment processor
+79 bps

EVERCORE
Investment bank
+79 bps

ENCOMPASS
In-patient rehabilitation provider
+76 bps

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In 2Q we had a strong contribution in total of 234 bps from our Top 3 performers. Payment processor WEX Inc. (WEX) rose 21.6% and contributed 79 bps. WEX has three business lines — payment processing for car and truck fleets; one time Mastercard payment processing (used by on-line travel agencies like Expedia to settle hotel bookings); and software and services used by providers of Health Savings Accounts (HSAs) in the U.S. WEX is benefiting from multiple rising tides: higher fuel prices mean more revenues on some contracts, miles driven is rising as is demand for HSAs, and travel spending continues to be robust. WEX also has enjoyed some stock specific good news including a new large contract with Shell and better loss and fraud prevention (preventing the use of credit card skimmers at gas pumps).

Investment bank Evercore Inc. (EVR) was up 21.5% and contributed 79 bps, as investors reacted well to both a strong earnings report and to the strong and increasing pace of mergers and acquisitions worldwide. Sentiment also benefited from several high profile hires as the company continues to execute on its strategy of opportunistically building a world class team.

In-patient rehabilitation, home health care, and hospice service provider Encompass Health Corp. (EHC) was up 18.8% and contributed 76 bps. Encompass was well positioned to benefit from investors' desire to hold U.S. only exposure as the company is a domestic operator and is unlikely to become collateral damage from a trade war. Demographic shifts also are pointing to increased use of the company's services as more of the population ages and gets sicker (e.g. post-stroke rehabilitation services), and dies (e.g. hospice services). Rising health care costs will continue to encourage the shift of care to the home which also benefits the home health business.

2ND QUARTER 2018

WINNERS AND LOSERS

SMALL-CAP COMPOSITE COMMENTARY

Top Detractors

Company	Quarter End Position Size	Contribution
Beacon Roofing Supply, Inc.	3.3%	-0.68%
Xperi Corp	1.8%	-0.49%
Hortonworks, Inc.	3.6%	-0.41%
Total		**-1.58%**

BEACON ROOFING SUPPLY
Roofing materials distributor
-68 bps

XPERI
Semi-conductor provider
-49 bps

HORTONWORKS
Open source big-data platform
-41 bps

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Our biggest three losers cost us at total of -158 bps. Roofing materials distributor Beacon Roofing Supply (BECN) stock was down 19.7% in the quarter which cost us 68 bps. There were a number of factors at work: 1) even though roofing is largely a replacement market, sentiment in the building group has been weak on fears of rising interest rates affecting demand for new housing; 2) investors are worried that Beacon will not be able to pass on manufacturers' price increases, further compressing gross margins; 3) weather related issues impacted fiscal second quarter results; and, 4) the acquisition of Allied Building Products created more balance sheet leverage. We believe the market's reaction to these concerns are overblown and feel BECN is a strong operator with a history of successfully integrating strategic acquisitions.

Xperi Corp. (XPER) a leading provider of technology solutions (chip packaging, imaging and audio) to the semi-conductor industry was down 22.9% in the quarter which cost us 49 bps. Despite a solid cash flow cushion to support valuation, the absence of news on the Samsung litigation (now expected next year) has all but caused a buyers' strike in this stock, and we are continuing to closely monitor the position.

Software company Hortonworks (HDP) was down 10.6% in the quarter which cost us 41 bps. This stock is a poster child for what ails this market — an investor fickleness that occasionally devolves into a mob mentality. A competitor whiffed earnings for company specific reasons, which resulted in a 50% haircut in that stock. In contrast, HDP's quarterly results were on target, but sentiment contagion took its toll, and the stock suffered from guilt by association. Hortonworks is the open source provider of big data solutions, and we see excellent long term growth potential. HDP is riding the wave of explosive growth in unstructured data and is well positioned to serve its clients' need to process mountains of data, both structured and unstructured, static and streaming, to make real time business decisions.

The net contribution of our best three minus our worst three positions was 76 bps, while the remainder of the portfolio generated another 468 bps.

2ND QUARTER 2018

SECTORS OF NOTE

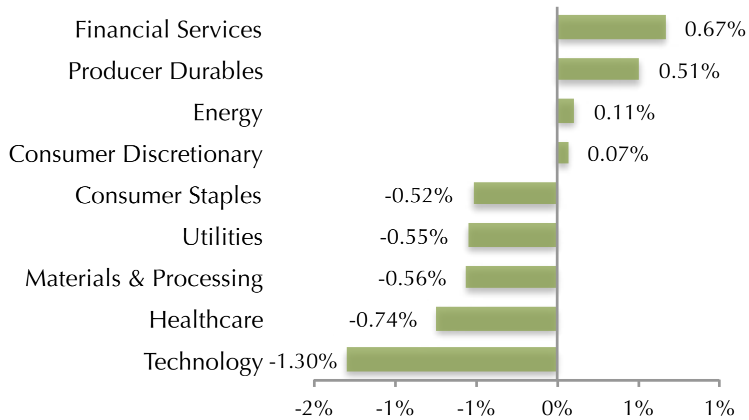
SMALL-CAP COMPOSITE COMMENTARY

Not owning REITs and Biotechs cost us a total of 136 bps relative to the Russell 2000. Our best contributors (on a relative basis) were Financial Services at 230 bps vs. 163 bps for the Index, thanks to WEX and Evercore, and Producer Durables 105 bps vs. 54 bps, due to 10%+ stock price increases in air freight servicer Atlas Air, real estate information service provider CoStar Group, and defense contractor Kratos.

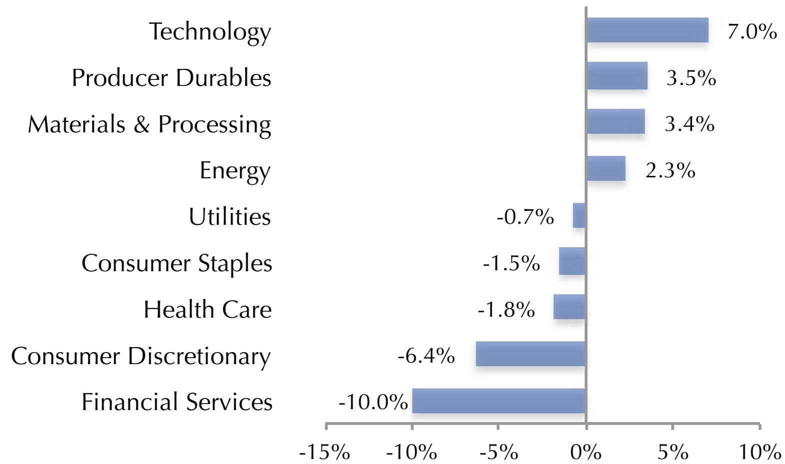
Technology by contrast was our worst performer detracting -22 bps while the Benchmark generated 108 bps. Our relative underperformance was largely stock specific (XPER and HDP as noted above). Health Care was also a disappointment, more from an absence of lift across the board (save for Encompass Health) in a sector that was up nicely.

The gap between Energy sector stocks and commodity prices, which had been puzzling in size and duration since the second half of 2017, narrowed sharply in the second quarter. The stocks with exposure to the Permian, however, were an exception and were punished by investor fear that lack of transport capacity out of the basin would slow development by raising production costs and squeezing producers' profitability.

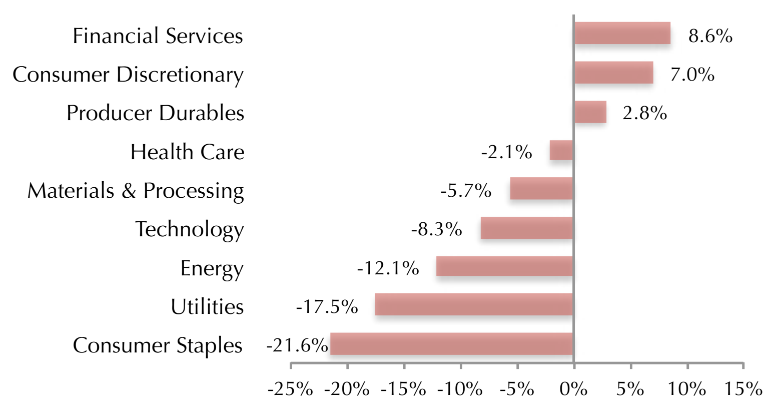
CONTRIBUTION DIFFERENCE DARUMA VS. R2000



DARUMA SECTOR OVER/UNDERWEIGHT VS. R2000



RETURNS DIFFERENCE DARUMA VS. R2000



Sources: FactSet, Russell Investments & Daruma Capital Management

2ND QUARTER 2018

DECILE ANALYSIS

SMALL-CAP COMPOSITE COMMENTARY

Given the recent rebalance of the Russell 2000, the decile returns for the second quarter do not foot to the actual Benchmark returns (as historical decile data are now based on current Russell constituents).

Having said that, there are some observations worthy of note in the patterns in this quarter's decile chart. Sales growth was clearly rewarded and the impact of ETF inflows can be seen in the outperformance of multiple decile categories.

Record flows lifted all boats but disproportionally rewarded lower quality market decile segments (e.g. lowest institutional ownership, highest betas, highest short interest, non-earning and lowest dividend yielding stocks.

The trend is even more pronounced in the year to date performance decile breakdown for the Russell 2000: Once again growth was rewarded and the lower quality deciles caught an even bigger lift from fund flows.

2Q 2018

Deciles	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
P/E Ratio (Lowest to Highest)*	10.0%	10.8%	12.9%	13.4%	9.9%	8.8%	11.2%	12.3%	13.9%	12.8%
Dividend Yield (Highest to Lowest)**	9.8%	7.9%	7.3%	8.4%	11.1%	-	-	-	-	13.8%
Short Interest (Lowest to Highest)	8.4%	8.4%	8.9%	10.4%	12.6%	11.5%	13.1%	9.7%	15.4%	17.1%
Beta (Lowest to Highest)	7.9%	12.2%	9.5%	9.5%	7.1%	9.5%	10.2%	9.5%	13.3%	26.8%
Sales Growth (Best to Worst)	17.8%	15.5%	11.3%	10.2%	9.2%	10.0%	8.7%	10.8%	8.6%	4.1%
Analyst Ratings (Best to Worst)	13.4%	12.1%	11.7%	12.0%	11.2%	14.7%	9.2%	10.5%	22.3%	7.1%
Institutional Ownership (Most to Least)***(*)	9.7%	10.0%	9.3%	8.3%	10.6%	12.2%	13.9%	12.0%	11.5%	18.3%
% Chg Q1 2018 (Best to Worst)^	14.8%	11.0%	10.1%	9.4%	8.7%	8.9%	9.1%	11.8%	10.2%	19.5%
% Chg in 2017 (Best to Worst)^^	14.5%	12.9%	6.9%	9.7%	7.4%	8.8%	9.2%	8.8%	10.9%	23.9%

2018 YTD

Deciles	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
P/E Ratio (Lowest to Highest)*	5.9%	12.0%	13.7%	14.8%	9.1%	11.0%	12.8%	16.2%	14.9%	19.3%
Dividend Yield (Highest to Lowest)**	2.3%	4.3%	7.0%	10.8%	12.7%	-	-	-	-	17.9%
Short Interest (Lowest to Highest)	10.0%	10.6%	12.3%	11.1%	15.3%	17.5%	15.9%	11.4%	14.2%	12.0%
Beta (Lowest to Highest)	13.9%	12.0%	13.0%	14.6%	6.9%	9.4%	10.3%	8.1%	11.8%	30.8%
Sales Growth (Best to Worst)	22.7%	20.5%	14.1%	12.5%	10.2%	9.6%	9.0%	8.3%	7.7%	5.3%
Analyst Ratings (Best to Worst)	20.3%	17.7%	14.2%	12.0%	14.1%	7.3%	8.2%	8.5%	19.1%	-2.5%
Institutional Ownership (Most to Least)***(*)	8.3%	9.7%	6.9%	8.9%	10.6%	14.9%	15.6%	16.7%	19.0%	20.3%
% Chg Q1 2018 (Best to Worst)^	75.4%	30.4%	20.2%	13.6%	8.8%	5.6%	2.1%	-0.0%	-7.7%	-17.8%
% Chg in 2017 (Best to Worst)^^	16.3%	16.5%	10.3%	13.5%	6.4%	8.7%	10.2%	6.5%	8.8%	33.3%

Sources: Bloomberg, Russell Investments & Daruma Capital Management

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

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

*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 Q1 2018 excludes stocks without complete performance

^^% Change in 2017 excludes stocks without complete performance

Note: Due to Russell Rebalance on 6/22/18 - actual benchmark returns may vary from decile results.

2ND QUARTER 2018

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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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