BARRON'S
# Hedge Funds
A Monthly Report

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Gordon's small-cap portfolios contain just two- or three-dozen names. A favorite is Insulet.

Matthew Furman for *Barron's*

## Talking With
## Mariko Gordon
Founder
Daruma Capital Management

# Zen And Small Stocks

**by Eric Uhlfelder**

MARIKO GORDON RECENTLY SET A PERSONAL RECORD: SHE passed through five airports in a single day. A stickler for detail and a believer in active money management, Gordon spends a lot of time checking out companies first-hand, usually working 12 hours a day, six days a week. She's a veritable whirling dervish, trying to keep pace with the stocks of small, striving companies that tend to move around as much as she does..

Thankfully, the ones Gordon has put in her firm's portfolios usually move up in price, as evident in the extraordinary results she has racked up since she started Daruma Capital Management 18 years ago. Between July 1995 and this past July—with just three down years—Daruma's Small-Cap Composite portfolio's annualized rate of return has been 13.06%, 4.4 percentage points a year better than its benchmark, the Russell 2000 (see table on page 30). Most of the money Daruma handles is in separately managed accounts.

The strong, long-term results have helped push Daruma's total assets to $2.2 billion, which also includes a three-year-old $118 million small/mid-cap portfolio and the two-year-old Daruma Ginkgo fund, a $335 million hedge vehicle that gives smaller investors lower-cost access to the same portfolio. Ginkgo investors can choose a flat 1% annual management fee or a 0.75% fee plus 10% of the amount by which the fund beats the index (if it does). It has a $1 million minimum.

Gordon, 51, credits her success to a fascination with how businesses work, a passion she developed while living over her parents' Hertz rent-a-car franchise in Pointe-à-Pitre, the economic capital of the French Caribbean island of Guadeloupe. "Between the time I was 2 up until I was 10," she recalls, "I would watch my parents work and wanted to learn what they were doing all day." Hard work and ambition are family traits. Her mother's family emigrated from Okinawa in *continued on page 30*

## Leaving Its Benchmark in the Dust

Daruma has consistently topped the market since its start in 1995.

| | 1-Year | 3-Year | 5-Year | 10-Year | Since Inception** |
|---|---|---|---|---|---|
| Daruma Small Cap Composite* | 39.51% | 17.31% | 11.99% | 11.77% | 13.06% |
| Russell 2000 | 34.75 | 18.72 | 9.45 | 9.60 | 8.62 |

*Annualized net returns as of 7/31 **7/28/95

Source: Daruma Capital Management

Japan to Hawaii to work on a plantation, ultimately buying a farm there, and her paternal grandfather rose from messenger to partner at a Wall Street brokerage firm.

These examples led Gordon to emphasize management skills in rating stocks.

After graduating with a literature degree from Princeton, she started out crunching numbers for New York asset manager Manning & Napier. She refined her focus by joining small-cap investor Chuck Royce in the late 1980s, after he had adopted a value orientation at Royce & Associates. He gave her a chance to manage a portfolio and taught her how to "cross-examine management."

But where Royce liked to own hundreds of stocks, Gordon "preferred the thrill of watching over a small number of positions." So when she started Daruma (the Japanese name of the founder of Zen Buddhism) in New York, she was bent on running a concentrated portfolio of 25 to 35 companies. This approach demands discipline because every position must carry its own weight.

Gordon's eight-person investment team searches for small-cap domestic companies whose business models are both efficient and easy to understand. The group not only seeks solid management but industry-pricing power. A value investor, it looks for opportunities in misunderstood, beaten-down stocks, where there's upside potential of at least 50% within two years. Daruma is also on the hunt for under appreciated drivers of sales, earnings, or cash-flow growth to power these gains.

**In 2010, as the** housing market was starting to flash signs of recovery, shares of the leading "do it yourself" wood-flooring retailer **Lumber Liquidators** (ticker: LL) were getting hammered. Sales growth softened and net margins contracted. Gordon attributed most of its problems to temporary glitches in new enterprise resource planning software, worries about possible tariffs on Chinese imports (where Lumber Liquidators gets 40% of its wood), and aggressive store expansion. She liked its new chief, Robert Lynch, who had gained valuable experience at **Home Depot** (HD) and **Wal-Mart Stores** (WMT).

Gordon took an initial position at $24 in December 2010 and then doubled down in 2011 when the stock fell further, to $15.

Lynch solved the operational problems, and the tariff threats didn't come to pass. He cut costs by buying his Chinese sourcing agent, thereby getting better pricing and eliminating commissions. Net margins, which fell to 2.9% in 2010, jumped to nearly 8% by June 2013, annual sales growth doubled to 19%, and the stock recently hit a high of $101.98.

In **Maximus** (MMS), Gordon & Co. spotted a way to profit from Obamacare. The well-run company acts as consultant and outsourcer for county, state, provincial, and federal governments, many of which have had to downsize substantially. In one of its two units, Maximus helps guide health-care recipients through the enrollment process. The U.S. government's push to get the uninsured into insurance exchanges should increase demand for Maximus services.

Another appeal: Maximus' minimal name recognition. There are few similar companies, analyst coverage is scant, and investors tend to compare its financials, wrongly, with giant defense contractors.

She bought the stock in April 2010 at $15, when it was trading at a forward price/earnings multiple of 14 while she projected 25% annual earnings growth. The stock recently traded near $40.

A manufacturer of insulin-delivery systems, **Insulet** (PODD) has created a small disposable "pump patch" called OmniPod. People with Type 1 diabetes can stick it on their skin (like a nicotine patch) to receive three days of insulin. Being the first to market gives the firm a distinct advantage in potentially serving a large segment of the 1.5 million Americans with the disease.

This spring, Gordon saw a buying opportunity when Insulet shares fell to $25 because of the Food and Drug Administration's protracted approval process of the OmniPod at the same time the company was trying to cope with the hefty expense of shifting production and marketing focus from a bigger pump to the smaller version.

With FDA approval now secured, Gordon thinks the OmniPod will push Insulet into the black by the end of this year, with revenue growth averaging 20% a year. As demand grows, the smaller system will enjoy lower production costs, helping drive gross margins from 44% in 2012 to the mid-60s in 2016.

In early August, the stock topped $30, and Gordon expects it to hit $38 by 2015.

Of course, not every Daruma investment works out so well. Still, the fund's name–which in Japan means achieving objectives through intense focus and the ability to resist forces that distract and harm–seems to fit the investment approach. ■