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DF Dent All Cap Growth Strategy

October 2017 Commentary

Portfolio Thoughts

With the U.S. economy slowly gaining ground, solid corporate earnings producing few major scares, and oil prices on the rise after a weak first half of 2017, the major stock indexes all produced modest single-digit gains for the quarter, with the S&P 500 hitting new all-time highs. Although there was plenty of disturbing news, including devastation from hurricanes and incessant political turmoil in Washington, D.C., the markets mostly shrugged it off.

For the third quarter of 2017, D.F. Dent's All Cap Growth strategy returned 6.06% vs. the Russell 3000 Growth Index total return of 5.93%. For the year-to-date through September 30, 2017, the total return from D.F. Dent's All Cap Growth strategy was 23.79% vs. the Russell 3000 Growth Index return of 20.43%.

Performance for the third quarter was positively impacted by stock selection in the Consumer Discretionary, Health Care and Financial sectors. Consumer Discretionary stocks had been a drag on performance for the first half of 2017 and that reversed in 3Q17. Performance was also helped by being underweight the Consumer Staples and the Consumer Discretionary sectors. These positive contributors were offset by stock selection in the Industrial and Technology sectors. Tech stocks have been strong contributors to the portfolio returns year-to-date, but took a breather in 3Q17.

3Q17

Ticker		Contribution To Return
	5 Highest	**2.80**
V	Visa Inc. Class A	0.66
RHT	Red Hat, Inc.	0.59
KMX	CarMax, Inc.	0.57
MCO	Moody's Corporation	0.52
ENV	Envestnet, Inc.	0.47
	5 Lowest	**-1.24**
WAB	Westinghouse Air Brake Technologies Corporation	-0.59
WAGE	WageWorks, Inc.	-0.23
PRO	PROS Holdings, Inc.	-0.22
ECL	Ecolab Inc.	-0.14
VRSK	Verisk Analytics Inc.	-0.06

The top three contributors during 3Q were:

- **Visa Inc. (V)**, the world's largest electronic payment network, reported fiscal third quarter results that exceeded market expectations for both revenues and net earnings. Transaction and payment volume growth were greater than expected, as Visa continues to lead the global transition from physical cash and check payments to digital payments. This trend is still early in its migration and has been given additional momentum from the pervasive growth of ecommerce. Management raised its fiscal year guidance for revenue growth from 16%-18% to ~20%, adjusted EPS growth from the high-end of mid-teens to ~20%, while lowering client incentive expectations. EU payment regulation has set the stage for faster volume growth and market share gains. This digital payment tailwind, coupled with excellent management execution and a market-leading position in an effective global duopoly, make Visa an attractive long-term investment for your portfolio.

- **Red Hat, Inc. (RHT)**, a leading open-source software company, continued its strong performance in 2017 by reporting another good quarter of solid revenue growth in its core Red Hat Enterprise Linux (RHEL) business and much faster growth in its Emerging Technologies business (including OpenStack and OpenShift). Operating margins have also begun to expand at RHT, which is a welcome sign for investors who have waited several years for margin leverage. Although RHT's valuation is not as attractive as it was when we began the year, IT infrastructure spending on the open-source hybrid cloud is a megatrend that shows no signs of slowdown, and we believe RHT will continue to grow its earnings at higher than a market rate for at least several more years. We trimmed our holding due to its higher valuation.

- **CarMax, Inc. (KMX**), the leading used car retailer in the U.S., reported solid second quarter results, exceeding expectations on units sold, profit margins and earnings per share. The strong results coupled with rising used car prices and an improving credit environment alleviated concerns regarding the profitability and cyclicality of the business. CarMax continues to benefit from spending initiatives in the technology space. The company is providing a true omni channel selling discipline whereby consumers are doing their homework before coming into the store ready to buy. These technology initiatives are becoming another growth driver to sales and continue to expand CarMax's moat. We believe that CarMax's superior customer experience offering, data analytics and business model will result in continued profitable growth and market share gains over the longer term. We trimmed our position at quarter end.

The top three detractors during 3Q were:

- **Westinghouse Air Brake Technologies Corporation (WAB)**, one of the world's largest providers of equipment and services for the global freight and transit railroad industries, reported second quarter results and a reduction in guidance that caused us to lose faith in management. We had our own reservations regarding the industry dynamics that we had raised to management months before they reported second quarter results. Management did not share our concerns. We had a difficult time reconciling their initial response to our concerns with their guidance reduction in this 2Q17 report, during which time we believe industry dynamics were largely unchanged. We exited our position.

- **WageWorks, Inc. (WAGE),** an administrator of consumer-directed benefit accounts for employers, continues to perform very well operationally and to deliver impressive revenue and earnings growth. However, the stock's underperformance has continued throughout 2017. We attribute this to (1) the stock having been ahead of itself after a strong 2016 and (2) a mid-year dilutive equity offering, which was perceived negatively by the market. We expect that the cash from this equity offering will be used primarily for mergers and acquisitions (M&A). Over the next six months, we anticipate continued strong operational performance, with possible M&A announcements. We added to the position during the quarter.

- **PROS Holdings (PRO),** a provider of pricing and revenue optimization software, gave back some gains after a strong second quarter. There were no clear headwinds other than speculation that Hurricane Harvey, which struck PRO's home base of Houston, may have caused a lull in sales activity. PRO reported solid second quarter results and announced the tuck-in acquisition of Vayant, a provider of shopping, pricing, and merchandising technology to the travel industry. We took advantage of the weakness to slightly increase positions.

<u>Market Thoughts</u>

The strong year-to-date performance in the US equity markets has come as a surprise to some after nine years of excellent returns. The strength has been backed up by strong corporate earnings, 2Q17 GDP growth of 3.1%, low unemployment, potential tax reform, and a global economic environment that appears to be gaining steam. Interestingly, the recent earnings season was the strongest we have seen in a while as 90% of your DF Dent portfolio companies beat consensus earnings estimates. This compares favorably to the long-term average of 65%-75%. We expect the continued strength in corporate profits will provide fundamental support for U.S. stock prices next year.

With the weaker U.S. dollar and higher global GDP growth as tailwinds, companies with greater exposure to revenues outside the U.S. should do better in the next quarter or two than companies with higher domestic exposure. While your DF Dent portfolio invests predominantly in U.S. based companies, 36% of the those companies aggregate revenues come from outside the U.S. Only four of your portfolio companies get 100% of their revenues from the U.S. Your DF Dent portfolio is positioned to participate in this potential tailwind, yet this position has been achieved with companies that have stricter U.S. accounting rules and management teams that we have met many times and know well.

While the near-term picture still looks mostly positive, there may be some clouds on the horizon. The S&P 500 Index has not had a 5% correction in over 330 days, the third longest period in history. This party may not last forever so we are constantly on the lookout for signs it is ending. Markets are at or near all-time highs, valuations are stretched, the climate in Washington, D.C. is bitter, and volatility is at historic lows. While inflation has been held in check, if it moves above the Fed's target, we could see greater increase in the pace of rate hikes than the market is currently expecting. Any shock to the system could cause volatility to spike and upend stock prices. We will remain focused on economic fundamentals and the long-term growth prospects for your portfolio companies.

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Finally, we'd like to welcome our newest employee, Brooke Hrimnak. Brooke recently joined the firm with fourteen years of experience in the investment industry. Prior to joining D.F. Dent and Company, she served as Head of Institutional Equity Sales at Wunderlich Securities, Inc. and Vice President of Corporate Services at Ferris, Baker Watts, Inc. Brooke will serve as a client relationship manager.

We appreciate the confidence you have placed in D.F. Dent and Co. We will continue to work diligently on your behalf.

This commentary can be found on our website (<u>www.dfdent.com</u>). We encourage you to refer to our website for other information about our firm and our investment products, including our mutual funds.