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DF Dent Midcap 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 Midcap Growth strategy returned 6.00% vs. the Russell Midcap Growth Index total return of 5.28%. For the year-to-date through September 30, 2017, the total return from D.F. Dent's Midcap Growth strategy is 23.69% vs. the Russell Midcap Growth Index total return of 17.29%.

Performance for the third quarter was positively impacted by stock selection in the Health Care, Consumer Discretionary 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 Consumer Discretionary sectors. These positive contributors were offset by stock selection in the Industrial, Technology, and Materials sectors. Tech stocks have been strong contributors for the portfolio year-to-date, but took a breather in 3Q17.

3Q17	Midcap	Average Weight	Total Return	Contribution To Return
	Total	**100.00**	**6.03**	**6.03**
	5 Highest	**19.13**	**17.67**	**3.20**
KMX	CarMax, Inc.	3.76	20.22	0.72
RHT	Red Hat, Inc.	4.72	15.78	0.72
MCO	Moody's Corporation	4.36	14.74	0.62
ENV	Envestnet, Inc.	2.29	28.79	0.61
SEIC	SEI Investments Company	4.00	13.54	0.53
	5 Lowest	**12.62**	**-11.74**	**-1.60**
WAB	Westinghouse Air Brake Technologies Corp	1.88	-17.08	-0.70
PRO	PROS Holdings, Inc.	2.79	-11.90	-0.35
WAGE	WageWorks, Inc.	2.93	-9.67	-0.28
DXCM	DexCom, Inc.	0.34	-26.80	-0.14
ECL	Ecolab Inc.	4.68	-2.84	-0.14

The top three contributors during 3Q were:

- **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.

- **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.

- **Moody's Corporation (MCO)**, a leading provider of credit ratings and related research, data, and analytical tools, reported a strong second quarter driven by better than expected results in the MIS (Ratings) division, especially international. Total revenues increased by 8% to $1 billion with recurring revenue (49% of the total) up 6%. Adjusted diluted eps increased 16% to $1.51. Management commented that strength in issuance was broad based, with strong growth in first time mandates. Guidance for 2017 was increased to account for the higher than predicted earnings in the 2nd quarter but management cautioned that 2nd half comparisons will be challenging due to a strong recovery in issuance in the second half of 2016. We trimmed the position on the strength.

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.

- **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.

- **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.

Market Thoughts

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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On November 1, 2017, D.F. Dent will launch a new institutional share class mutual fund for our Midcap Growth and Small Cap Growth strategies and will be geared toward institutional buyers. Please contact our Client Service team at 410-837-2544 if you would like to learn more.

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 (www.dfdent.com). We encourage you to refer to our website for other information about our firm and our investment products, including our mutual funds.