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DF Dent Small Cap Growth Strategy

April 2018 Commentary

Strong equity returns in January gave way to weaker returns in February and March. The S&P 500 return was slightly negative for the quarter. This was the first quarter since 2008 that both stocks and bonds lost money while there was a positive return from cash. The quarter was marked by an increase in volatility, which had been subdued in the prior few years.

Portfolio Thoughts

For the first quarter of 2018, D.F. Dent's Small Cap Growth strategy returned 3.77% (gross of fees) vs. the Russell 2000 Growth Index total return of 2.30%. Strong performance was broad based. Results were positively impacted by stock selection in the Technology, Healthcare and Consumer Staples sectors. The strategy's underweight position in Energy also helped performance for the quarter. These positive contributors were offset slightly by stock selection in the Industrials sector and being overweight in Industrials.

During the first quarter, the Russell 2000 Growth declined by 1% or more on eleven different days. DF Dent's Small Cap Growth strategy outperformed on ten of those eleven days and the cumulative outperformance of those eleven days was 393 basis points. We believe the outperformance on those sharp down days was due to the high quality nature of our portfolio.

During the quarter, the Small Cap strategy added one new name, Brooks Automation, and exited five names, LCI Corp., Liberty Trip Advisors, Steris, Shutterfly, and SPS Commerce.

- **Brooks Automation (BRKS)** provides precise, reliable handling of sensitive materials in controlled environments. It operates through two business segments, Brooks Semiconductor Solutions Group and Brooks Life Sciences Systems. The Semiconductor business provides transport, vacuum, and contamination control solutions and services for semiconductor wafer fabrication. The Life Sciences Systems segment provides automated cold storage systems, consumables for bio-sample storage, and outsourced cold storage services. The company offers a strong value proposition for clients as it prevents fab contamination and provides efficient sample storage.

- **LCI Corp. (LCII)** is an OEM supplier to RV manufacturers, which is a highly cyclical industry driven by discretionary consumer spending. While the RV industry has seen very healthy demand in the past few years, we worry about the up-cycle being extended. In addition, LCII's valuation was elevated, so we decided to exit our position in the first quarter.

- **Liberty Trip Advisor (LTRPA)** owns shares in Tripadvisor, Inc. (TRIP) which operates a best-in-class website for travelers to research trips and destinations. Several long-term trends in the market place are creating headwinds for TripAdvisor so the company is currently engaging in a TV ad campaign to educate consumers about the price comparison and shopping features. This campaign will be dilutive to earnings initially. We are skeptical about the long-term success of the current campaign and decided to exit our position by taking advantage of a short-term price strength.

- **Shutterfly (SFLY)** is the largest digital printing service providing personalized photo-based products. A new management team came on board in 2016 and they have improved business performance. The stock has performed well in the portfolio, but we are concerned about the seasonality of the business and the potential increase in competition. We decided to exit our position in the first quarter.

- **SPSCommerce (SPSC)** is a cloud based supply chain management solutions company serving retail customers. With the rise of e-commerce and online shopping, most of SPSC's retail customers are struggling with slow growth. For the few retail companies who are investing in technology, the focus tends to be on the customer facing "front-end". We do not expect SPSC's slower growth will reaccelerate any time soon, so we exited the position in the first quarter.

- **Steris (STE)** provides infection prevention products and services to hospitals and healthcare product manufacturers. STE was initially purchased in 2016. The stock appreciated approximately 30% in 2017 and exceeded our assessment of fair value. We began selling the name in 2017 and finished in 2018.

1Q18

Ticker		Contribution To Return
	5 Highest	**3.17**
TYL	Tyler Technologies, Inc.	0.84
PRO	PROS Holdings, Inc.	0.82
CSGP	CoStar Group, Inc.	0.52
BL	BlackLine, Inc.	0.51
TECH	Bio-Techne Corporation	0.47
	5 Lowest	**-2.72**
WAGE	WageWorks, Inc.	-0.81
CFX	Colfax Corporation	-0.69
BECN	Beacon Roofing Supply, Inc.	-0.43
KIDS	OrthoPediatrics Corp.	-0.41
HCSG	Healthcare Services Group, Inc.	-0.38

The top three contributors during 1Q were:

- **Tyler Technologies (TYL),** a software company serving state and municipal governments, performed nicely amidst strong 4Q earnings and bookings figures. TYL's efforts to better integrate its various software offerings are driving strong market share gains. For example, TYL is currently integrating its public safety, court, and jail software systems in an effort to reduce costs and improve efficiencies for customers. We view TYL as one of the best businesses in the portfolio and as a core long-term position.

- **PROS Holdings (PRO),** a provider of pricing and revenue optimization software, reported a strong finish to 2017 with solid growth in its annualized recurring revenue ("ARR"). PRO's strong operating progress throughout 2017 has further validated management's decision to transition toward a subscription-based business model and to offer more of its products in smaller size "bites" with an eye toward eventual follow-on sales. We continue to have confidence in PRO and see its core offering- data-driven pricing and revenue optimization- as being extraordinarily well-positioned for secular growth.

- **CoStar Group, Inc. (CSGP),** the leading provider of information, analytics and marketing services to the commercial real estate market, reported fourth quarter results with bookings that exceeded expectations. These bookings should support stronger top line growth assumptions looking out over the next year and give investors added confidence in the longer-term opportunity. The guidance given for 2018 appears to be conservative. Increased profitability will be temporarily weighed down by internal expenses as they invest in growth. We expect that CoStar's margin trajectory will turn upward as they move beyond these recent investments to support growth. We believe that CoStar is uniquely positioned with significant barriers to entry and we anticipate profitable growth over the next few years.

The top three detractors during 1Q were:

- **WageWorks (WAGE),** an administrator of consumer-directed benefit accounts for employers, has been a significant detractor to performance. First, there were concerns regarding potentially slower growth in consumer-directed benefit accounts which weighed on the stock. This general concern was compounded by a company-specific concern regarding a delayed 10-K filing. According to WAGE and its auditors, the delay relates to questions about the timing of revenue recognition on some of WAGE's largest, most complex contracts. While we believe the revenue recognition issues are relatively minor in dollar terms and will likely relate to timing rather than revenue legitimacy, we take these issues very seriously and are monitoring the situation closely.

- **Colfax Corporation (CFX),** a manufacturer of Fabrication Technology (welding) and Air & Gas Handling products, disappointed the Street by not increasing its 2018 guidance despite a reduction in the expected tax rate. However, at ~15x management's 2018 adjusted EPS guidance the market is not giving CFX credit for the possibility of 1) achieving mid-teens segment margins in 3-4 years or 2) an attractive platform acquisition in the near future. If CFX achieves their $3.00 adjusted EPS target, we would expect potential stock returns in the mid-to-high teens from here. While achieving the $3.00 target will not be easy, the probability of achieving it is underestimated by the market.

- **Beacon Roofing Supply, Inc (BECN),** one of the largest roofing and building materials distributors in the U.S., underperformed in Q1. The stock finished 2017 near all-time highs and we reduced our position in the 4th quarter. The company's fiscal Q1 results (reported in February) were above expectations on top line strength, though the company was not able to fully pass through higher material and transportation costs which hurt margins in the quarter. 2018 guidance calls for healthy volume growth and price increases. The company will start to realize significant synergies from its acquisition of Allied Building Products. We continue to hold BECN as a core position.

Market Thoughts

At D.F. Dent, we remain positive on the equity markets in the near-term, since there is fundamental support and the global economy is performing well. In the U.S., data on employment, GDP growth, and industrial production are positive. Corporate earnings are seeing a benefit from recently-passed tax reform. Interest rates, while rising, are still not yet in restrictive territory. At the same time, we have concerns about how far the equity markets have come. Late stage bull markets can get very jubilant but eventually roll over. As we said last quarter, liquidity is the lifeblood of the markets. With the Fed becoming more restrictive, liquidity appears poised to tighten.

In such an environment, investors tend to gravitate towards higher quality stocks, which are the exact type of stocks in which DF Dent invests. Our portfolio companies have strong balance sheets, low debt, stable and predictable earnings, thoughtful uses for reinvesting cash, and talented and ethical management teams. While the volatility makes the short term ride very bumpy, we maintain a long-term view of equities. If we have learned anything in the last 15 months, it is that we have entered more of a stock pickers market. As stock pickers, D.F. Dent views volatility as opportunity. We will continue to use market volatility to the advantage of our clients.

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