DF Dent All Cap Growth Strategy

July 2018 Commentary

Positive returns in the second quarter of 2018 helped US equities outperform most other asset classes and geographies. Earnings growth has been a source of strength for growth companies and has helped drive stock performance. Growth outperformed value in the quarter. Small caps have outperformed large caps for the second quarter and the first half of 2018 backed by a stronger US economy and concerns over global growth. Volatility has increased with the VIX +4% in June over rising trade tensions.

Portfolio Thoughts

	2Q18	YTD 2018
All Cap Growth (gross)	5.21%	10.86%
All Cap Growth (net)	5.05%	10.53%
Russell 3000 Growth Index	5.87%	7.44%
S&P 500 Index	3.43%	2.65%

For the second quarter of 2018, D.F. Dent's All Cap Growth strategy slightly underperformed the Russell 3000 Growth Index and outperformed the S&P 500 Index. Relative performance against the Russell index was hurt by sector allocation and helped by stock selection. The portfolio was negatively impacted by being overweight the Technology and Industrial sectors and being underweight the Consumer Discretionary sector. Technology stock selection also was a detractor to performance this quarter but has been a positive influence on performance for the year. We had been trimming our Technology stocks after a strong 2017 and 1Q18 as their valuations continued to reach higher. On the positive side, strong stock selection in Industrials helped performance. This was a nice reversal from 2017 where stock selection in Industrials had been a detractor. The portfolio also benefitted from our underweight position in Consumer Staples, where we have no exposure.

During the quarter, the All Cap Growth strategy added two new names, Black Knight Inc. and SBA Communications. The strategy exited one name during the quarter, Discover Financial Services.

- **Black Knight Inc. (BKI)** is the leading provider of mortgage servicing platform (MSP) software. BKI is leveraging its strong MSP position to cross-sell additional products to its blue-chip, financial customer base, such as loan origination software (LOS) and data & analytics (D&A). BKI has highly visible, recurring revenue (over 90%), high customer retention (~99%), and room to grow in its MSP, LOS, and D&A business lines in addition to developing new products over time. Executive Chairman William Foley has a long term track record of success and we trust he will do an excellent job overseeing the allocation of BKI substantial free cash flow.

- **SBA Communications (SBAC)** is a leading global owner, operator, and developer of cellular communication towers. We own SBAC because we believe that demand for wireless data will continue to grow, and, in order to meet this demand, wireless carriers will need to add more communications equipment (antennas) to existing tower sites and will require more tower sites as they densify their networks. In addition to annual pricing escalators, this increased demand for tower space should lead to steady revenue growth for SBAC at very high incremental margins. We initiated a position in SBAC during the 2Q as hand wringing over a merger between Sprint and T-Mobile and the threat of rising interest rates caused the stock to underperform. We saw the chance to invest in a great business and management team that we have followed and owned for many years in our Midcap strategy.

- **Discover Financial Services (DFS)** operates as a direct banking (Discover-branded credit cards) and payment services company (the Discover Network) in the United States. Although the stock is reasonably valued and operationally doing well, we sold the stock because banking profits could slow versus investors' expectations with the flattening yield curve. We expect a deterioration in credit spreads which historically has not been good for financial stocks. Additionally, we lost confidence in the optionality of the network being spun off from the bank, which would have created another competitive network. While the company's fundamentals remain sound, its longer-term EPS growth prospects have normalized, and we used the stock as a source of funds to add to positions we believe have greater return potential.

Ticker	2Q18	Contribution To Return
	5 Largest Contributors	**2.60**
V	Visa Inc. Class A	0.62
ILMN	Illumina, Inc.	0.52
AMZN	Amazon.com, Inc.	0.51
KMX	CarMax, Inc.	0.50
CLB	Core Laboratories NV	0.45
	5 Largest Detractors	**-1.31**
SEIC	SEI Investments Company	-0.39
LKQ	LKQ Corporation	-0.29
FAST	Fastenal Company	-0.28
RHT	Red Hat, Inc.	-0.21
CELG	Celgene Corporation	-0.15

The top three contributors during 2Q were:

- **Visa Inc. (V),** the world's largest electronic payment network, reported fiscal second quarter results that exceeded market expectations for both revenues and net earnings. Transaction and payment volume growth were strong, as V continues to lead the global transition from cash and check payments to digital payments. This trend is still early in its migration and has been accelerated by the pervasive growth of ecommerce. Management raised its fiscal year growth guidance to the low-double-digits for revenues and the high 20% range for EPS. The integration of Visa Europe is providing a nice tailwind and is tracking ahead of expectations. We believe this digital payment tailwind, coupled with excellent management execution and a market-leading position in a global duopoly, make V an attractive long-term investment.

- **Illumina, Inc (ILMN)**, a leader in sequencing and array-based solutions for genomic analysis, benefitted from continued uptake of its new NovaSeq instrument and related consumables, indicating that the replacement cycle for sequencing equipment is likely larger than investors had anticipated. Favorable reimbursement decisions from Medicare and private insurers have also been positives. The applications for ILMN's technology are still in an early stage, particularly in clinical markets. We expect the total addressable market (TAM) to continue to expand as more applications are discovered for genomic sequencing.

- **Amazon.com, Inc. (AMZN)**, a global leader in e-commerce and cloud computing, continued to perform well in the quarter. The company reported very strong financial results, beating consensus estimates. Amazon Web Services (AWS), Prime, and advertising all reported very strong growth with very high profit margins. Even with impressive top line growth, AMZN's earnings power is growing even faster. We expect the company's growth in both revenue and profitability to continue in the foreseeable future as the company invests aggressively in areas with large market potential and good strategic fit, as demonstrated by its recent announcement to acquire the online pharmacy Pillpack.

The top three detractors during 2Q were:

- **SEI Investments Co. (SEIC)**, a provider of investment-related services and IT platforms, traded off after announcing that key client Wells Fargo will be postponing its implementation date. Wells is a marquee client for SEIC's new SEI Wealth Platform infrastructure solution. SEIC declined to provide a revised date which, while appropriate given client confidentiality considerations, heightened investor concerns. Our sense is that the postponement will likely prove much shorter than feared. We are encouraged that management, as disclosed in an 8K, has significantly increased share repurchase activity since the stock's slide. We continue to expect strong earnings growth in 2018 as operating profitability inflects positively and SEIC benefits from tax reform.

- **LKQ Corp. (LKQ)**, a distributor of recycled and alternative automotive parts, fell sharply after reporting disappointing 1Q results on multiple fronts. LKQ suffered unexpected margin pressure in the U.S. driven by cost inflation issues as well as, ironically, expenses incurred to satisfy strong customer demand. This was accompanied by cost pressures in the U.K. relating to unusual March snowstorms and the opening of a large new distribution center. We were disappointed by management's execution during the quarter but believe that at least some of the 1Q headwinds will prove temporary in nature. However, given valuation we view the stock's risk-reward as attractive here.

- **Fastenal Co. (FAST)**, a distributor of fasteners and industrial supplies, retreated on fears relating to how tariffs and steel inflation may impact FAST and its customer base. After quarter-end, the stock recovered when FAST reported better-than-expected 2Q results. We continue to expect earnings growth to accelerate in the second half of this year as gross margin comps ease and operating expense leverage expands as FAST's incentive compensation is now fully rebuilt. While tariff and inflation fears involve uncertainty and are difficult to handicap, the recovery in the North American energy industry should be highly beneficial to much of FAST's industrial customer base. With the stock near a 10-year low relative valuation, we continue to see the risk-reward as favorable. We increased positions in the 2Q.

Market Thoughts

How much longer? This is a question that many parents hear when stuck in traffic with their kids in the back seat. It is also a question we are constantly asking ourselves these days in the tenth year of a bull market (with the fundamentals of your portfolio companies as strong as ever). How much higher and how much longer can the bull market go? Not a surprise, but we have no good answer and do not want to let our short-term guesses determine the long-term construction of your portfolio. We do realize that all good things come to an end, but at this time we do not see fundamentals as being the reason for a market decline.

From a technical perspective, market breadth – the number of stocks advancing relative to the number declining - is often a leading indicator of market performance, with declining market breadth signaling weak future performance. Market breadth continues to hit new highs, so it still appears that we are in a bull market. We also have not yet seen the typical early warning signs of a coming recession. However, the overall market environment has been in the process of changing. The market environment has gone from being the beneficiary of a strong expansionary monetary policy and some fiscal discipline to an environment of tightening monetary policy and expansionary fiscal policy (large tax cuts). We believe that monetary policy is a more important driver of stock market multiples (and returns) than fiscal policy. We also fear that the huge fiscal stimulus from tax cuts will boost growth temporarily but will leave the economy with a hangover at some point in the near future. Therefore, we think the current state of affairs probably means we have reached the end of the continued multiple expansion of price-to-earnings ratios that has driven the market higher in recent years. In order for the market to continue to work higher, it is corporate profit growth that will have to carry the day. In fact, we believe that corporate profits (the "e" in "p/e") will grow nicely for the remainder of 2018. Since the market typically discounts economic performance 6-9 months in the future, the key will be earnings growth in 2019 and 2020. Given how long the economic expansion has gone on, the market will be on guard for signs of a slowing or recessionary environment in the next two years. We are keeping a close eye on concerns about rising interest rates, unsustainable valuations, and tariff wars, among other data points.

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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.