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DF Dent Midcap 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
Midcap Growth (gross)	3.81%	9.48%
Midcap Growth (net)	3.66%	9.18%
Russell Midcap Growth Index	3.16%	5.40%

For the second quarter of 2018, D.F. Dent's Midcap Growth strategy outperformed the Russell Midcap Growth Index. Relative performance against the Russell index was driven by positive stock selection. The portfolio was positively impacted by stock selection in the Industrial, Technology, and Health Care sectors. The Industrial stock benefit was a nice reversal from 2017 where stock selection in that sector had been a detractor to performance. This was slightly offset by stock selection in Consumer Discretionary, Financials, and Real Estate. The overweight weighting in Industrials was also a slight drag on performance.

During the quarter, the Midcap Growth strategy added one new name, Black Knight Inc., and exited one name, AAC Holdings.

- **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's substantial free cash flow.

- **AAC Holdings (AAC)** provides inpatient and outpatient treatments for individuals with drug and alcohol addiction, including detoxification, residential treatment, partial hospitalization and intensive outpatient care. The stock recovered to a level that we viewed as an attractive exit point. AAC's inpatient centers face a headwind as payers are pushing for less severe patients to pursue cheaper outpatient treatment. Our comfort with management's execution and capital allocation had diminished and we were opportunistically looking for an exit.

Ticker	2Q18	Contribution To Return
	5 Largest Contributors	**2.61**
ILMN	Illumina, Inc.	0.70
KMX	CarMax, Inc.	0.54
CLB	Core Laboratories NV	0.54
GWR	Genesee & Wyoming, Inc. Class A	0.42
ANSS	ANSYS, Inc.	0.42
	5 Largest Detractors	**-1.76**
SEIC	SEI Investments Company	-0.52
LKQ	LKQ Corporation	-0.46
FAST	Fastenal Company	-0.29
RHT	Red Hat, Inc.	-0.27
TRMB	Trimble Inc.	-0.23

The top three contributors during 2Q were:

- **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 for the stock. 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.

- **CarMax, Inc. (KMX)**, the leading used car retailer in the U.S., reported relatively strong first quarter results, exceeding expectations on same-store-sales (SSS), units sold, auto financing income, and earnings per share. Earlier this year, the gap between new and used car prices narrowed as OEMs offered higher incentives on new cars while used car pricing remained strong. More recently, those headwinds have faded, allowing KMX to show significantly improved sequential SSS trends. The combination of strong late-model used car supply and easier SSS comparisons should result in strong sales performance in the near term. Also, as a domestically focused company, KMX should meaningfully benefit from tax reform in 2018 and beyond. We believe that their superior customer experience offering, data analytics, and business model should drive continued profitable growth and long-term market share gains.

- **Core Laboratories N.V. (CLB)**, a leading oil service company with a focus on reservoir description and production enhancement, performed well in the second quarter as the company gave an optimistic outlook for the rest of the year as global oil and gas activities continue to recover. While the US market continued to drive healthy growth, the company called the bottom of its international business and expects growth going forward. The global oil market backdrop is also very healthy with declining inventory providing support or even upward pressure for oil prices. We believe CLB is well positioned in this market backdrop and its earnings and cash flow will continue to grow for the next several years.

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.