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DF Dent Small 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.

<u>Portfolio Thoughts</u>

	2Q18	YTD 2018
Small Cap Growth (gross)	7.97%	12.02%
Small Cap Growth (net)	7.71%	11.57%
Russell 2000 Growth Index	7.23%	9.70%

For the second quarter of 2018, D.F. Dent's Small Cap Growth strategy outperformed the Russell 2000 Growth Index. Relative performance against the Russell index was driven by positive stock selection. The portfolio was positively impacted by stock selection in the Technology, and Health Care and Telecom Services sectors. Being underweight the Materials sector also helped performance. This was slightly offset by stock selection in the Industrial, Consumer Discretionary and Real Estate sectors. Our overweight position in Industrials was also a drag on performance.

During the quarter, the Small Cap Growth strategy added four new names.

- **MGP Ingredients, Inc. (MGPI)** is a leading supplier of distilled spirits in the U.S. It is taking share in the growing American whiskey market as it leverages its scale, blending expertise, and strategic supply of already aged whiskeys. MGPI is uniquely positioned to support its customers' growth and capitalize on the resurging preference for premium American whiskeys. With MGPI's mix shifting to more aged and branded spirits, we believe the company can grow its operating income 15%-20% per year over the long-term.

- **Cantel Medical Corp. (CMD)** is a leading manufacturer of infection prevention products for the healthcare market. It has dominant market positions in all of its three main business segments: endoscopy, water purification and filtration, and healthcare disposables. We believe the company still has plenty room for growth driven by new product introductions, international expansion and acquisitions. We believe the company can grow its long-term revenue and earnings per share by approximately 15% per year.

- **LeMaitre Vascular (LMAT)** is a medical device company focused on the peripheral vascular disease market. The company manufactures and markets surgical devices and implants used in open vascular surgeries, such as catheters, shunts, biological patches, and vascular grafts. LMAT enjoys healthy profit margins and strong pricing power due to its strong market position. We believe the company can grow its earnings per share by 15%-20% over the long-term.

- **MINDBODY, Inc. (MB)** is a leading provider of cloud-based software to boutique fitness, wellness and beauty services, such as yoga studios, spas and salons. Its software not only performs critical functions for its customers but also enjoys a powerful network effect as more users enhance the relevance of the MINDBODY app. We believe the health and wellness industry should continue its secular growth and the company can grow its top-line 15%-20% a year for many years.

The Small Cap Growth strategy exited two names in the past quarter.

- **ProAssurance Corporation (PRA)** is a leader in the medical malpractice and worker's comp market. But several developing trends in the market could negatively impact the company's long-term profitability. Consolidation of physician practices increases the market power of its customers and also drives claims severity higher. At the same time, competition and excess capital create pressure on the industry's pricing power. In addition, rising interest rates serve to hurt PRA's investment portfolio which is dominated by fixed income securities. Even with these headwinds, the company's valuation was still not very cheap at 1.6X Price/Book, so we exited our position.

- **CoreLogic, Inc. (CLGX)** is a provider of real estate property information, data and analytics. Despite its attractive valuation, the company struggles to articulate its long-term strategic focus. In addition, the company's growth is mostly driven by acquisitions, but management does not provide enough transparency to allow us understand organic growth rates and acquisition integration. Given our limited ability to develop a deep understanding of CLGX's business and strategies, we decided to exit our position with a healthy gain and redeploy the capital elsewhere.

Ticker	2Q18	Contribution To Return
	5 Largest Contributors	**4.04**
KIDS	OrthoPediatrics Corp.	1.16
MLAB	Mesa Laboratories, Inc.	0.90
W	Wayfair, Inc. Class A	0.85
EVTC	EVERTEC, Inc.	0.60
DXCM	DexCom, Inc.	0.52
	5 Largest Detractors	**-1.99**
BECN	Beacon Roofing Supply, Inc.	-0.53
JBT	John Bean Technologies Corporation	-0.39
CSV	Carriage Services Inc.	-0.39
MIDD	Middleby Corporation	-0.35
AAC	AAC Holdings, Inc.	-0.32

The top three contributors during 2Q were:

- **OrthoPediatrics Corp. (KIDS)**, an orthopedic medical device manufacturer with a sole focus on pediatric patients, performed well in the quarter after reporting solid results for 1Q18. The company's growth accelerated and beat management's guidance by a healthy margin. In addition, the company provided guidance for the rest of the year that we believe is conservative. As KIDS invests its IPO proceeds to support the increasing demand for its products and the rapid pace of innovation, we expect the company to maintain or exceed revenue growth of over 20% per year for at least the next several years.

- **Mesa Laboratories, Inc. (MLAB)**, a niche focused manufacturer of instrument and disposable products for the healthcare, pharmaceutical, and food and beverage industries, appreciated significantly in Q2 after the company reported healthy revenue growth and strong margin expansion in Q1. These results energized the market as they could be early signs that the new CEO and his management team are making good progress optimizing the operations of the company. Having met with the company recently, we believe it has the right long-term strategy, and could be at the beginning of a long runway of operations optimization, rejuvenation of organic growth, and re-start of the acquisition engine.

- **Wayfair, Inc. (W)**, a leading online furniture and home goods retailer, posted solid first quarter results exceeding revenue growth expectations while reporting EBITDA in-line with estimates. Management provided information which alleviated investor concerns over customer acquisition costs. We continue to like W for its culture of data-driven decision making, operational discipline, and an unwavering focus on the customer. We believe it will continue to take market share from brick and mortar furniture retailers.

The top three detractors during 2Q were:

- **Beacon Roofing Supply, Inc (BECN)** is one of the largest roofing and building materials distributors in the U.S. The company reported weak fiscal Q2 (calendar Q1) results due to rapidly rising costs and prolonged winter weather delaying roofing demand. But we believe the majority of the headwinds BECN and the industry are facing are temporary, and we expect the company to offset higher costs with price increases in 2018. Coupled with moderate volume growth, we believe industry fundamentals and Beacon's results are poised to improve as the year goes on, so we added to our position following the pull-back in share price.

- **John Bean Technologies Corp. (JBT)**, a leading manufacturer of food processing equipment and airport ground support equipment, was weak in the quarter after the company reported 1Q18 results that missed its own guidance. As a result, JBT reduced its full year guidance for earnings per share. But most of the issues in Q1 have been fixed quickly and the company believes it has enough visibility to achieve its full year revenue guidance. We believe JBT is a very compelling long-term investment and the company is still in relatively early stages of growing its topline and improving operating margins.

- **Carriage Services. Inc. (CSV)**, a leading operator and consolidator in the death care industry, saw its share price pull back in 2Q18 after meaningful appreciation in 1Q. We believe the stock's under-performance was the result of 1) a guidance reduction due to an acquisition that was previously announced but not completed and 2) the issuance of fairly expensive debt (6.625%) and equity to recapitalize the company. While these factors certainly "muddied the waters" for

CSV in the short term, we continue to like the long term outlook for the company and we believe they can grow its free cash flow per share in the low-to-mid teens.

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.