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DF Dent Midcap Growth Strategy

October 2018 Commentary

U.S. equities outperformed most other asset classes in the third quarter of 2018, including Treasuries, corporate bonds, gold and cash. U.S. large cap equities outperformed global equities due to strong earnings, a strong U.S. dollar, and the perception that, in any trade war, the U.S. would be hurt less than others, especially emerging economies. Health Care was the best performing sector in the U.S., taking the lead from Information Technology, which was more volatile in the quarter.

Portfolio Thoughts

	3Q18	YTD 2018
Midcap Growth (gross)	7.62%	17.82%
Midcap Growth (net)	7.48%	17.35%
Russell Midcap Growth Index	7.57%	13.38%

For the third quarter of 2018, D.F. Dent's Midcap Growth strategy modestly outperformed the Russell Midcap Growth Index. For the year, D.F. Dent's Midcap Growth strategy continued to show strong outperformance vs. the benchmark. The companies in the portfolio experienced strong corporate earnings reports during the quarter, with 82% of the portfolio names beating or meeting consensus earnings expectations. This is higher than our typical 65-70% rate. Relative performance against the Russell Index was driven by positive stock selection. The portfolio was positively impacted by stock selection in the Health Care and Materials sectors. The portfolio also benefited by its underweight positions in the new Communication Services sector and Consumer Discretionary. This was slightly offset by stock selection in the Technology and Industrial sectors. The overweighting in Real Estate was also a slight drag on performance.

During the quarter, the Midcap Growth strategy added one new name, A.O. Smith Corp. and exited one name, Exponent Inc.

- **A.O. Smith Corp. (AOS)** is a leading manufacturer of residential and commercial water heaters, boilers and water treatment products. The core North American market has strong pricing power in an oligopoly where the top 3 players control >90% market share. The business model is recession-resistant with 85% of its North American water heater and boiler volumes driven by replacement demand. AOS has been operating in China for 20 years and has leading market share in hot water heaters, as well as a rapidly growing water treatment business. Over the next decade, we expect China's growing middle class to consume more of AOS's products including new products that help with air purification.

- **Exponent, Inc. (EXPO)** is a leading engineering and scientific consulting company in the U.S. serving clients in the industrial, consumer products, and other end markets. Many of EXPO's engagements are initiated (1) by lawyers and/or insurance companies whose clients anticipate or are engaged in litigation and (2) by large corporations seeking proactive assistance on complex technologies. We exited the stock because EXPO's relative valuation had climbed significantly over the last quarter to a 10-year high. With expectations of 9% to 12% EPS growth, even with excellent management and corporate culture, clean earnings, and a very strong balance sheet, we felt this 38x forward P/E valuation was "as good as it gets" and believe that multiple compression is likely from here.

Ticker	3Q18	Contribution To Return
	5 Largest Contributors	**4.58**
ILMN	Illumina, Inc.	1.15
TECH	Bio-Techne Corporation	0.95
TRMB	Trimble Inc.	0.87
BL	BlackLine, Inc.	0.86
FAST	Fastenal Company	0.75
	5 Largest Detractors	**-0.90**
CLB	Core Laboratories NV	-0.29
CBRE	CBRE Group, Inc. Class A	-0.22
HCSG	Healthcare Services Group, Inc.	-0.16
WAGE	WageWorks, Inc.	-0.15
AOS	A. O. Smith Corporation	-0.08

The top three contributors during 3Q 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 once again that the replacement cycle for sequencing equipment is likely larger than investors had anticipated. 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. However, we recognize that ILMN's earnings growth has not quite kept up with the stock's multiple expansion, so we have trimmed the position.

- **Bio-Techne Corp. (TECH)** designs and manufacturers best-in-class reagents and instruments for the life science research and clinical diagnostics markets. The stock performed well in the quarter as TECH reported a very strong quarter with organic revenue and EPS beating consensus estimates. The company provided a very healthy outlook for fiscal 2019. In addition, TECH has continued to make acquisitions in innovative technologies that could expand their addressable market. Finally, TECH held an analyst day during the quarter where it unveiled a new five-year strategic plan calling for continued strong growth and healthy profit margin expansion. Given the management team's excellent track record, the new five-year plan was very well received by the market.

- **Trimble, Inc. (TRMB),** a technology and software provider to construction, agriculture, transportation, and other industries, reported its eighth straight quarter of results above consensus estimates. The company's organic growth remained in the double-digits and, more importantly, Trimble showed significant improvement in margins. This improvement was driven in large part by a continued shift away from hardware sales and toward software, services, and other recurring sources of revenue, a trend which should continue longer-term. We believe the company's improved business model, characterized by higher margins and more stable revenue streams, is becoming more apparent in results and supports our expectation of mid-teens earnings growth long-term.

The top three detractors during 3Q were:

- **Core Laboratories NV (CLB)** is a leading oil service company in reservoir description and production enhancement. It is a very unique company in the oil and gas industry due to its low capital intensity, high free cash flow and high return on investment. CLB stock was weak in the quarter because the company issued a warning before it reported-quarterly results that were below estimates. Despite healthy growth in its U.S. business, the company's international business has been slow to recover from lower oil prices. Management had expected international project activities to ramp up during the quarter, but many of CLB customers have been slow to spend their budgets. The company expects project delays, not cancellations. We still like CLB's business and its management team in an otherwise very cyclical industry.

- **CBRE Group, Inc. (CBRE),** the leading commercial real estate services firm, reported decent quarterly results. However, CBRE's stock price began to decline materially after its largest competitor, Jones Lang LaSalle (JLL), reported results that disappointed the Street owing to weaker than expected margin performance. We continue to like CBRE's management, leading industry position, and long term growth prospects and think that the recent decline in the stock price was unwarranted. Accordingly, we recently added to our positions.

- **Healthcare Services Group, Inc. (HCSG)** provides housekeeping, laundry and dietary services to long-term care facilities. HCSG stock was weak in the quarter because its earnings report was weaker than expected. Revenue and EPS both missed consensus estimates despite reasonable year-over-year growth. More importantly, the company's gross margin was dampened by onboarding costs for a big new client in 2017. Until the company can get its gross margin back to historical levels, the stock is likely to remain a "show me" stock. However, management has made some progress in gross margin improvement and expects both margins and growth to normalize beginning in 2019.

Market Thoughts

The U.S. equity market continued to perform well in the quarter, and there is underlying fundamental support for this strength. The economy is doing well, as GDP growth has expanded. S&P earnings growth increased 19.3% in the most recent quarter, the highest rate since the first quarter of 2011, although part of the recent growth is attributable to tax reform. We have seen record share repurchases this year by U.S. corporations as well as 48-year lows in U.S. unemployment. At the end of the day, equity markets typically rise when economic growth is strong.

However, looking forward we see headwinds facing the equity markets. Liquidity is one of the most important pieces of the investment puzzle in determining the direction of the stock market and there are some long-term trends that could hamper future liquidity. U.S. and foreign central banks have substantially increased their balance sheets since the Great Recession through quantitative easing. They are reversing this trend. At the same time, debt, which was a cause of the Great Recession, continues to grow at high rates both here and abroad. This growth is in both the government and corporate markets. It is only the artificially low interest rates prescribed by central banks that has kept these higher debt loads serviceable for now.

Corporate profits should grow nicely for the remainder of 2018 due to the ongoing benefits from tax reform and the respectable pace of economic growth. However, the rate of earnings growth is expected to subside in 2019, with the consensus forecast +10.3%. We do not want to be alarmists, but these are trends that need to be considered in today's investment environment. The liquidity tailwind could easily become a headwind over the next few years, even without a recession, and financial assets are likely to be impacted. The combination of that dynamic along with slower earnings growth and historically high valuations suggests lower equity returns from here.

How is D.F. Dent preparing for a lower return U.S. stock market? As a reminder, D.F. Dent is a bottom-up investor focused on owning high quality U.S. growth equities managed by talented and ethical management teams. First, we are not making sweeping changes to your portfolio. We have been trimming positions that have dramatically outperformed and, as a result, have extended valuations (EXPO, ILMN). We are redeploying that money into new and existing names with more reasonable valuations and a higher expected 3-5 year return. (AOS, BKI, CBRE). Given our high-quality stock bias and our deep due diligence on the strength of management and the business models, we believe that many of your portfolio companies can earn their way through any market doldrums that may occur in the next few years. Without Fed easing as a tailwind, stock picking may become even more important in the near term. If individual companies are valued even more closely on their financial performance, we believe your D.F. Dent portfolio is well positioned for the future.

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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.