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DF Dent Small Cap 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
Small Cap Growth (gross)	8.92%	22.01%
Small Cap Growth (net)	8.82%	21.45%
Russell 2000 Growth Index	5.52%	15.76%

For the third quarter of 2018, D.F. Dent's Small Cap Growth strategy outperformed the Russell 2000 Growth Index. For the year, D.F. Dent's Small Cap Growth strategy continued to show strong outperformance vs. the benchmark. Relative performance against the Russell Index was driven by stock selection. The portfolio was positively impacted by stock selection in the Health Care, Industrials and Consumer Discretionary sectors. The strategy's overweight in Technology and underweight in Energy also added to performance. This was slightly offset by stock selection in the Technology and Financials sectors.

During the quarter, the Small Cap Growth strategy added five new names, Watsco, Inc., Black Knight, Inc., Eventbrite, Inc., Redfin Corp, and EVO Payments, Inc. and exited two names, Carter's, Inc. and AAON, Inc.

- **Watsco, Inc. (WSO)** is the leading independent distributor of HVAC equipment, parts and supplies. Watsco is attractive due to the "must have" nature of its products (air conditioning in the Sun Belt), the fragmented nature of the industry, the exclusive distribution rights for certain Watsco products and the inability to ship many of Watsco's products through a parcel distribution network (lower Amazon risk). Through a combination of infrequent M&A and organic growth, we expect Watsco will continue to gain market share. We are also intrigued by Watsco's significant investments in technology, which could lead to an acceleration of market share gains. We expect all of these factors to result in low-double digit EPS growth, which, when combined with Watsco's ~3% dividend, results in a very attractive total return.

- **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.

- **EventBrite, Inc. (EB)** is a software company serving the event planning market. Its cloud-based software is used by event creators of all sizes to manage event registration, ticketing, onsite sales, marketing, analytics, and other related functions. The event planning software market is extremely fragmented, but EventBrite is the largest provider in the lower priced "self-serve" market and is about 20 times the size of its next largest competitor. Relative to its ~$200 million in revenue, the global addressable market for its products is very large at $14 billion. We believe the company can grow its revenue at the pace of 20%-25% in the foreseeable future.

- **Redfin Corp. (RDFN)** is a technology-powered residential real estate brokerage. The company is a small player in the U.S. real estate market today, but it is growing quickly as it aims to disrupt an $80 billion market with a significantly differentiated business model supported by better technology, an improved customer experience, and significantly reduced cost to customers. Led by a highly capable and transparent management team, we believe Redfin will be a long-term winner in the real estate market. With the company still in the early innings of its growth, we believe Redfin can sustain over 20% top-line growth for the next few years with improving profitability.

- **EVO Payments, Inc. (EVOP)** is a merchant acquirer and payment processor with a growing global footprint. The company focuses on markets which have high secular growth potential but are too small for large competitors to focus on. It relies on both organic initiatives as well as acquisitions for growth. The company is led by a very experienced CEO, Jim Kelly, who has successfully implemented similar strategies before. We believe the company can grow revenue organically in the high-single-digit to 10% range and that acquisitions will further enhance its growth. Margin expansion will also serve as a significant source of earnings growth as the company benefits from larger scale as it grows.

- **Carter's, Inc. (CRI)** is a leading designer and marketer of apparel for babies and young children. The company sells its products under two main brands, Carter's and Oshkosh, as well as several other brands. However, many of their major retailer customers, such as Toys "R" Us (bankrupt), are not doing well due to the market's shift towards e-commerce and online shopping. This will disrupt Carter's traditional sales and distribution channels and require the company to make large investments in e-commerce to remain competitive. We believe the company's earnings growth potential going forward will not be as strong so we exited the stock.

- **AAON, Inc. (AAON)** is a provider of premium commercial heating, ventilation, and air conditioning (HVAC) products. The company focuses on the higher end of the market and sells its products on customization, quality, and performance. The company has been suffering from manufacturing efficiency issues and struggled to deliver customer orders on time. We expect these issues to continue until the company makes significant investments in systems and talent to upgrade its manufacturing capabilities. We decided to exit our position and will revisit the investment when there is visibility that the manufacturing issues will be fixed.

Ticker	3Q18	Contribution To Return
	5 Largest Contributors	**4.68**
DXCM	DexCom, Inc.	1.10
TECH	Bio-Techne Corporation	1.05
HEI.A	HEICO Corporation Class A	0.85
KIDS	OrthoPediatrics Corp.	0.84
BL	BlackLine, Inc.	0.82
	5 Largest Detractors	**-1.56**
BECN	Beacon Roofing Supply, Inc.	-0.41
CSV	Carriage Services Inc.	-0.32
WAGE	WageWorks, Inc.	-0.31
SITE	SiteOne Landscape Supply, Inc.	-0.27
LAD	Lithia Motors, Inc. Class A	-0.26

The top three contributors during 3Q were:

- **DexCom, Inc. (DXCM)** is a pioneer and leader in continuous glucose monitoring (CGM) technologies for the management of diabetes. DXCM performed well in 3Q as they reported exceptionally strong quarterly results. The company reported revenue growth of 42% in the quarter beating consensus estimates of 20% as demand for DXCM's CGM technologies accelerated with strength in different market segments. Management increased full year guidance for 2018 and the new guidance is likely conservative. The company's newly launched G6 products could drive very strong growth for the rest of 2018 and into 2019. In addition, the company is also making rapid progress on its product pipeline and establishing new payment models to get more payer coverage of their products. Under this excellent management team, we believe DXCM will continue its rapid growth and leadership in the diabetes care market. We trimmed the position on strength in the quarter.

- **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 its 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. We trimmed the position on strength in the quarter.

- **HEICO Corp. (HEI.A)** designs and manufactures products for the aerospace, defense and electronics markets. The stock outperformed in Q3 because the company reported very strong financial results. Both revenue and earnings beat consensus estimates. The company's Flight Support Group (FSG) and Electronics Technologies Group (ETG) both reported very strong organic growth that hasn't been seen for a while. Profit margins also expanded nicely as a result of strong growth. Management increased its full year guidance for 2018. We believe HEICO is a very good business managed by talented owner operators and we expect its steady growth to continue. We trimmed the position on strength in the quarter.

The top three detractors during 3Q were:

- **Beacon Roofing Supply, Inc. (BECN),** a leading distributor of roofing and building materials, has been hampered by difficult conditions in the roofing market in 2018. The company has made significant progress in rolling out price increases to offset material cost inflation which pinched margins in the first half of the year, but volume has also underwhelmed as growth in fundamental demand has not been robust enough to offset weather-driven weakness. Given the highly replacement-dependent nature of roofing demand, we believe volume will normalize over time. Coupled with continued recovery in gross margin and execution on acquisition-related synergies, we expect BECN to generate substantial growth in free cash and earnings. We added to the position on weakness in the quarter.

- **Carriage Services, Inc. (CSV),** a leading operator and consolidator in the deathcare industry, reported earnings results that were weak on an operating basis and very messy due to a previously announced balance sheet restructuring. The weak operating results in 2Q were driven by demand being pulled forward into 1Q due to an above average flu season in addition to an acceleration in the cremation rate. The latter is a profitability headwind for CSV. Both of these factors affected the entire industry, and we think that it is likely that CSV's demand trends will return to normal in 2019. We continue to like the long term outlook for CSV, which should include free cash flow per share growth in the low-to-mid teens, and think that underlying growth rate will become more apparent once the optics of the balance sheet restructuring and unusual 2018 demand trends are behind the company.

- **WageWorks, Inc. (WAGE)** is the leading provider of consumer-directed benefit accounts, which provides significant tax benefits to both employers and employees. WAGE stock was weak in 3Q and for the year because the company's auditor discovered some financial reporting errors. This triggered a prolonged audit that has delayed the company's 2017 and 2018 SEC filings. The audit also led to the departure of the company's CEO, CFO and general counsel. However, we continue to like the company's business and believe the new management team is focused on the right issues. When the audit process is completed, we think a financial restatement will likely be limited and have no impact on cash flow. We believe the stock should perform better in the next several quarters.

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. We are redeploying that money into new and existing names with more reasonable valuations and a higher expected 3-5 year return. 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.