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DF Dent All Cap Growth Strategy

January 2019 Commentary

In December, the S&P 500's total return was -9.45% which made it the worst December since the Great Depression; in the fourth quarter of 2018, the S&P 500 declined -13.52%. A promising year disappeared in the last ninety days. What happened? There were several issues which combined to weigh heavily on the market. First, economic growth began to slow at the same time stock valuations were high. Second, the era of low interest rates and easy money has been replaced by lower liquidity conditions. And third, uncertainty created by Washington has curbed investment spending growth. The equity markets, which crave stability, have suffered as a result. For 2018, the S&P 500 declined 4.38%, yet the average S&P stock fell 9.65%. Weightings mattered.

Portfolio Thoughts

Given the dislocations in the equity markets in the fourth quarter, we took advantage of the volatility to add to existing holdings where we saw compelling opportunities. The source of funds for these purchases came from existing cash or trimming some strong performers whose relative attractiveness lessened. Across your portfolio, we want to own high quality companies that are well managed and have good growth prospects. While these high quality companies are not immune to market downdrafts like we saw in the fourth quarter, we have high conviction that these companies will be good long term holdings for your portfolio. Of note, **Red Hat Inc. (RHT),** announced its pending sale to IBM in late October at a 60%+ premium. We viewed RHT, which we had owned for over five years, as a best-in-class technology company with leading if not dominant franchises and a strong management team. While we are sorry that such a great company will eventually leave the portfolio, we certainly were pleased to see RHT's strong franchise value recognized in the M&A market.

Market Thoughts

In our last commentary, we said that liquidity is the lifeblood of markets. Since the Great Financial Crisis, there has been an unprecedented expansion of liquidity by central banks around the world, including the United States Federal Reserve, as they have expanded their balance sheets from $4 trillion to $16 trillion. Financial asset valuations have benefitted. With the Fed finally reducing its balance sheet and other central banks likely to follow in 2019 and 2020, market participants have realized that this historic expansion of liquidity is coming to an end. We attribute recent market declines to this wind-down, along with the likelihood of forthcoming interest rate hikes, trade and geopolitical uncertainty, and general dysfunction in Washington.

Where do we go from here? We don't know if a bear market is imminent, but bear markets with declines of 30% or more are usually associated with recessions. Barring an unforeseen "black swan" event, a U.S. recession seems highly unlikely in 2019. While the economy is benefitting from significant government stimulus, there are few other cyclical areas of the economy that show signs of overheating. The classic warning signs of a recession are not apparent. Investors should be prepared, though, for prolonged uncertainty to drive continued volatility. The Fed finds itself in a quandary. If it keeps raising interest rates while shrinking its balance sheet at the same time, liquidity is reduced. On the other hand, should the Fed pause on raising rates, investors may worry that the Fed sees a weaker economy and slower profit growth. The market action of the last 90 days is a wakeup call for investors that the easy money has been made. We expect higher volatility over the near term. While this brings startling headlines and causes fear, it also creates trading opportunities for patient investors like D.F. Dent.

Our conclusion is that investors should expect lower absolute returns with more volatility in coming years as the liquidity tailwind abates. Several key catalysts of the multi-decade bull market - falling interest rates, falling tax rates, expanding profit margins, and increasing debt leverage - have likely played out, suggesting that equity returns should be lower over the next decade. Strong returns will more likely be driven by stock-picking than by a broad rising tide. While diversification remains important, we believe the best returns longer-term will still come from equities. Given the recent pullback in the equity markets, valuations have become more attractive. We believe your D.F. Dent portfolio is well positioned for growth going forward.

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We are excited to announce that Carolyn Gaynor has been promoted to Chief Compliance Officer effective January 1, 2019. Carolyn has worked closely with Gary Mitchell in compliance since she started at D.F. Dent in 2013 and has been a tremendous asset to the firm. Gary Mitchell is handing over the Chief Compliance Officer role to Carolyn, so he can devote more time to research and portfolio management.

We appreciate the confidence you have placed in D.F. Dent and Co. We will continue to work diligently on your behalf.