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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 Second, the era of low interest rates and easy money has been replaced by lower liquidity conditions.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

	4Q18	YTD 2018
All Cap Growth (gross)	-14.29%	2.91%
All Cap Growth (net)	-14.43%	2.32%
Russell 3000 Growth Index	-16.33%	-2.12%

For the fourth quarter of 2018, D.F. Dent's All Cap Growth strategy outperformed the Russell 3000 Growth Index. For the year, D.F. Dent's All Cap Growth strategy showed strong relative outperformance vs. the benchmark. While it is a small consolation to beat the benchmark in such a difficult quarter, relative outperformance was driven by stock selection. The portfolio was positively impacted by stock selection in the Industrial, Technology and Materials sectors. These same sectors benefitted performance for the year, as well. This was offset by negative stock selection in the Energy, Healthcare and Consumer Discretionary sectors. The portfolio's underweight position in Consumer Staples also hurt relative performance in the quarter. Given the dislocations in the equity markets, we took advantage of the volatility to add to existing holdings where we saw compelling opportunities. Additionally, as seen below, we added five new names to the portfolio. The source of funds for these purchases came from trimming some strong performers whose relative attractiveness lessened (e.g., VRSK, ECL, AMT, ILMN) and eliminating two positions.

New Additions to the Portfolio:

- **Okta Inc. (OKTA)** is a leader in Identity Access Management. Its Identity Cloud platform enables users to access any technology securely from any location and on any device. The company's solutions eliminate duplicative, sprawling credentials and disparate authentication policies across applications and technologies, allowing enterprise and SMB customers to scale their IT infrastructure more efficiently. Okta's neutral platform stands to benefit from significant network effects and increasing adoption of SaaS, public cloud, and mobile applications. We believe Okta is very well positioned to grow its industry leading market share and is likely to grow its revenue and earnings power over 30% annually in the intermediate term.

- **Qualys Inc. (QLYS)** is a leading provider of cloud-based cybersecurity and compliance solutions to enterprise and small and midsize business customers. Its flagship product is a Vulnerability Management (VM) solution, which enables customers to scan devices on their networks for both security and compliance purposes. Qualys's cloud-based delivery and integrated applications not only allow customers to save significant IT operating expenses but also expedite the migration of businesses to the cloud. With frequent breaches of corporate and government networks, cybersecurity will have a strong wind at its back for many years. We believe Qualys can grow its revenues at a high-teens rate and its EPS at a low-20% rate annually over the intermediate term.

- **Teleflex Inc. (TFX)** designs and manufactures a portfolio of medical devices used in critical care, surgical, urological and respiratory applications. The company is set to see significant improvement in both organic growth rate and profit margins due to a favorable mix shift towards higher growth and higher profitability products, particularly Urolift, a promising product for benign prostate hyperplasia that has the potential to achieve revenue in the multi-billion dollar range. In addition, we believe the TFX management team will continue to improve operating efficiency and upgrade its business portfolio through acquisitions and divestitures. We believe TFX will significantly outperform the general market over the next 3-5 years.

- **Thermo Fisher Scientific Inc. (TMO)** is the self-described "leader in serving science." TMO manufactures high value instruments and consumables and distributes those products, in addition to third party products, to end users that are conducting scientific research in a number of industries, including pharmaceutical, material, industrial, and healthcare, as well as government and academia. TMO also provides a wide array of services to those customers. We believe that TMO has a favorable industry backdrop, a substantial distribution channel, significant domain expertise, a talented CEO, and a track record of solid earnings growth. We believe that TMO can generate mid-single-digit organic revenue growth that will result in EPS growth in the mid-teens when combined with share repurchases and M&A.

- **TransUnion (TRU)** is a leading information services company with advantaged, legacy credit bureau assets. TransUnion is benefitting from a number of secular tailwinds, such as the increasing use of data analytics and machine learning, cyber security/fraud prevention, and increasing availability of consumer credit in international markets in which the company operates. We believe TransUnion can grow earnings per share at a high-teens rate through an economic cycle. We initiated our position in TRU after the stock declined on a 3Q18 "beat and raise" that was less than the Street expected and the company announced that CEO James Peck would be retiring. We believe that the new CEO, Christopher Cartwright, will be a capable successor to Mr. Peck, as Mr. Cartwright previously led TRU's largest division as well as product development.

<u>Positions exited in the portfolio:</u>

- **Red Hat Inc. (RHT),** a leading open-source software company, announced in late October 2018 that it would be acquired by IBM. The all-cash deal at $190/share represented a premium of more than 60%. We viewed a superior offer as unlikely. With the deal offering a somewhat-fixed expected payout, RHT outperformed amidst the 4Q market weakness, prompting us to use RHT as a source of funds to purchase other names that we believed offer a more attractive expected return going forward.

- **Watsco, Inc. (WSO)** is the leading independent HVAC distributor. We decided to exit our position after WSO reported another disappointing quarter with respect to sales and profitability. At the same time, the recent market turbulence provided an opportunity to reinvest in higher quality companies with better expected returns. While we continue to like WSO's industry structure, the company's performance has been below our initial expectations. We are becoming increasingly concerned that WSO may be losing market share and that the tailwind from the early 2000's "echo boom" replacement cycle may be behind the company.

Ticker	4Q18	Contribution To Return
	5 Largest Contributors	**0.74**
RHT	Red Hat, Inc.	0.58
AMT	American Tower Corporation	0.27
SBAC	SBA Communications Corp. Class A	0.03
HCSG	Healthcare Services Group, Inc.	-0.05
DHR	Danaher Corporation	-0.09
	5 Largest Detractors	**-4.44**
CLB	Core Laboratories NV	-1.22
AMZN	Amazon.com, Inc.	-0.98
ANSS	ANSYS, Inc.	-0.75
TECH	Bio-Techne Corporation	-0.75
V	Visa Inc. Class A	-0.74

The top three contributors during 4Q were:

- **Red Hat Inc. (RHT),** as mentioned earlier, 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 struggle to embrace the notion that IBM is RHT's logical owner, we certainly were pleased to see RHT's strong franchise value recognized in the M&A market.

- **American Tower Corp. (AMT),** a leading owner, operator, and developer of cellular communication towers around the world, reported 3Q18 results that were essentially in-line. AMT also announced that it reached a settlement with Tata in India, which provided clarity and, hopefully, "cleared the decks" with regard to total Indian churn expectations. This said, we believe the primary drivers of AMT's outperformance were the market's concern over a possible economic slowdown combined with a decline in long-term interest rates. AMT's revenue growth is not cyclical, suggesting outperformance in a sluggish economy, and AMT's debt levels are elevated. We believe that the long-term growth outlook for AMT remains positive and we continue to think highly of management. However, given the strong performance during the quarter, we trimmed our positions to reinvest proceeds into names whose expected returns improved as a result of market turbulence.

- **SBA Communications Corp. (SBAC),** also a leading owner, operator, and developer of global cellular communication towers, reported 3Q18 results that were slightly ahead of Street expectations. Like AMT, we believe SBAC outperformed due to the combination of the market's concern over a possible economic slowdown and a decline in long-term interest rates. We continue to be optimistic regarding SBAC's long-term growth outlook and remain very confident in management.

The top three detractors during 4Q were:

- **Core Laboratories NV (CLB)** is a leading oil service company offering reservoir description and production enhancement services. CLB stock was weak in the fourth quarter due to the precipitous drop in the price of oil and the ensuing slowdown in U.S. shale drilling activities. The oil market had anticipated a tightening supply situation following President Trump's renewal of sanctions on Iran. However, the Trump administration instead allowed waivers of the sanctions that have created an oversupply situation which probably will not be remedied until the second half of 2019. Recent reports of slower Chinese growth added to concern over the oil supply-demand imbalance. In the meantime, the 3.65% current dividend yield is safe, and we would not be surprised to see the company repurchasing stock at current levels.

- **Amazon.com, Inc. (AMZN),** is a leading global e-commerce retailer and a pioneer in the cloud computing market. AMZN's stock performance was weak in the 4Q despite a very strong 3Q earnings report. The stock was negatively impacted by some signs that the company's growth in U.S. first-party e-commerce may be slowing down. We believe these concerns are misplaced for two reasons. First, the company still has many significant growth drivers embedded in its current business and AMZN constantly experiments in new markets with very large growth potential (pharmaceutical distribution, for example). Second, even if AMZN's U.S. first-party business is growing at a slower pace, the company's profitability is improving dramatically, reaping benefits from years of investments. In addition, the company's profit growth should significantly outpace its revenue growth. We added to the position in the quarter.

- **ANSYS, Inc. (ANSS),** a developer and marketer of simulation software and services to engineers and product designers, has continued to perform very well operationally. Deeper relationships with ANSS's largest enterprise customers resulted in larger deal sizes and impressive bookings numbers. ANSS suffered in the 4Q from multiple compression in the software space, which may persist for the foreseeable future. However, we remain confident in ANSS' long-term growth opportunities and believe that its EPS growth - driven by strong organic revenue growth, some margin expansion, acquisition activity, and stock repurchases - will support above-market stock price appreciation even without multiple expansion.

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.