DF DENT
AND COMPANY, INC.
INVESTMENT COUNSEL
EST. 1976

DF Dent Midcap 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%. Midcap stocks underperformed large cap stocks in the fourth quarter, with the Russell Midcap Index declining -15.37%. 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 Second, the era of low interest rates and easy money has been replaced by lower liquidity conditions.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
Midcap Growth (gross)	-14.63%	0.57%
Midcap Growth (net)	-14.77%	0.01%
Russell Midap Growth Index	-15.99%	-4.75%

For the fourth quarter of 2018, D.F. Dent's Midcap Growth strategy outperformed the Russell Midcap Growth Index. For the year, D.F. Dent's Midcap 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 and Materials sectors. These same sectors benefitted performance throughout the year, as well. Performance was also helped by being overweight the Real Estate sector. This was offset by negative stock selection in the Energy and Consumer Discretionary sectors. The portfolio's underweight position in Consumer Staples and overweight position in Industrials also impacted 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 four new names to the portfolio. The source of funds for these purchases came from trimming some strong performers whose relative attractiveness lessened (ex. VRSK, ECL, CSGP) and eliminating three 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.

- **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.

Positions exited in the portfolio:

- **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.

- **WageWorks (WAGE**), an administrator of consumer-directed benefit accounts for employers, has had issues stemming from its last 10-Q filing. The company and its auditors continue to conduct a review of the company's financial statements and its revenue recognition policies. Although we suspect the worst is over in WAGE's accounting issues, we sold the stock in 4Q to purchase higher conviction ideas. We lost confidence in the previous management team and do not believe that the new management team has righted the ship. Additionally, our projected revenue and EPS growth rates for WAGE have declined over the past 6 months, making the name relatively less attractive.

- **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	**0.97**
RHT	Red Hat, Inc.	1.30
SBAC	SBA Communications Corp. Class A	0.04
HCSG	Healthcare Services Group, Inc.	-0.04
BKI	Black Knight, Inc.	-0.16
AOS	A. O. Smith Corporation	-0.17
	5 Largest Detractors	**-5.24**
CLB	Core Laboratories NV	-1.52
TECH	Bio-Techne Corporation	-0.99
ANSS	ANSYS, Inc.	-0.98
BL	BlackLine, Inc.	-0.89
TYL	Tyler Technologies, Inc.	-0.86

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.

- **SBA Communications Corp. (SBAC),** a leading owner, operator, and developer of global cellular communication towers, reported 3Q18 results that were slightly ahead of Street expectations. 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. SBAC's revenue growth is not cyclical, suggesting outperformance in a sluggish economy, and its debt levels are elevated. We continue to be optimistic regarding SBAC's long-term growth outlook and remain very confident in management's operational expertise.

- **Healthcare Services Group (HCSG),** a provider of housekeeping, laundry and dietary services to long-term care and related health care facilities, reported a weak 3Q and announced an adjustment to two regional operator agreements. This caused volatility in the stock. On the positive side, however, the company gave a conservative 2019 outlook that we believe sets up the stock well for next year. We view 2019 as a year of meeting or beating consensus estimates along with cash flow improvement. We believe HCSG is a unique, secular growth story with stable margins, low capital requirements, and a large addressable market. This said, we trimmed the position during the quarter to fund other ideas that we saw as relatively more compelling.

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.

- **Bio-Techne Corp. (TECH)** designs and manufacturers best-in-class reagents and instruments for the life science research and clinical diagnostics markets. The stock underperformed in 4Q because the company's largest acquisition, Exosome, may see slower commercialization of their tests than expected. This is TECH's first entry into a market that relies on insurance reimbursement, and investors are nervous about potential setbacks associated with Exosome. Long-term, we see little impact to TECH's stock from a slower launch of Exosome because Exosome has an innovative technology with a large addressable market. In time, it should contribute significant revenue and growth to TECH.

- **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 the 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.

*****

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.