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

DF Dent Small 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%. Small Cap equities lagged the other major U.S. indices as evidenced by the Russell 2000 Index returning -20.20% for the fourth quarter. 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 Second, the era of low interest rates and easy money has been replaced by lower liquidity conditions.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
Small Cap Growth (gross)	-18.26%	-0.27%
Small Cap Growth (net)	-18.44%	-1.04%
Russell 2000 Growth Index	-21.65%	-9.31%

For the fourth 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 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 and asset allocation. The portfolio was positively impacted by stock selection in the Technology, Consumer Discretionary, Industrial, and Health Care sectors. The portfolio also benefitted from being underweight the Health Care and Energy sectors and by being overweight the Technology sector. This was offset by negative stock selection in the Communication Services and Consumer Staples sectors. 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 six new names to the portfolio. The source of funds for these purchases came from eliminating nine positions and trimming some strong performers whose relative attractiveness lessened.

New Additions to the Portfolio:

The small cap portfolio added six names to the portfolio in the fourth quarter. Three names were added in the technology space. **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. **Novanta Inc. (NOVT)** is a leading supplier of photonics, vision, and precision motion components to industrial and medical equipment markets. **Qualys Inc. (QLYS)** is a leading provider of cloud-based cybersecurity and compliance solutions to enterprise and small and midsize business customers. We added one industrial name, **Helios Technologies (SNHY)**, a niche focused supplier of hydraulic valves and electronics going through a transformation to rejuvenate growth and improve profit margins. In financials, we added **Hamilton Lane (HLNE)**, one of the largest allocators of capital to private market investment vehicles on behalf of its clients. In healthcare we added **Vapotherm (VAPO)**, a medical technology company with an innovative oxygen delivery system for patients suffering from respiratory distress.

Positions exited in the portfolio:

We exited nine names in the small cap portfolio in the fourth quarter. The weak stock market presented an opportunity to buy some high quality businesses at compelling prices. Some existing holdings were used as a source of funds for these purchases. We exited some of these holdings because we were less optimistic about the company's market opportunity, business model, or management's ability to operate the business and make sound capital allocation decisions. Redeploying capital from these names into higher quality businesses improves the portfolio. The names we exited were **AAC Holdings (AAC)**, a national operator of substance abuse and behavioral rehabilitation facilities; **Carriage Services, Inc. (CSV)**, a provider of funeral and cemetary services in the US; **Colfax Corporation (CFX)**, a manufacturer of fabrication technology and air & gas handing products; **Computer Modelling Group (CMG-CA)**, a Canadian developer of reservoir simulation software for the oil and gas industry; **Ellie Mae (ELLI)**, a provider of mortgage loan origination software; and **IMAX (IMAX)**, an entertainment technology company engaged in motion picture technologies and presentations. We also exited several names that, despite our continued confidence in the companies, had stretched valuations. These names included **Atrion (ATRI)**, a niche focused manufacturer of medical devices and components; **Glacier Bancorp (GBCI)**, a regional commercial bank with operations in Montana and several neighboring states; and **Rexnord (RXN)**, a manufacturer of process and motion control and water management products. We took the opportunity to redeploy capital to more attractive names.

Ticker	4Q18	Contribution To Return
	5 Largest Contributors	**1.17**
VAPO	Vapotherm, Inc.	0.42
MLAB	Mesa Laboratories, Inc.	0.27
EVTC	EVERTEC, Inc.	0.21
OKTA	Okta, Inc. Class A	0.17
WDFC	WD-40 Company	0.11
	5 Largest Detractors	**-4.64**
TYL	Tyler Technologies, Inc.	-1.00
JBT	John Bean Technologies Corporation	-0.94
TECH	Bio-Techne Corporation	-0.94
CFX	Colfax Corporation	-0.93
BLKB	Blackbaud, Inc.	-0.82

The top three contributors during 4Q were:

- **Vapotherm, Inc. (VAPO)** is a medical device manufacturer with an innovative oxygen delivery system for for patients suffering from respiratory distress. Its stock performed well in 4Q18 on no news after the company's IPO in November 2018. We attribute this outperformance to continued discovery and purchase after their IPO by the investor community. Due to the stock's limited public float, VAPO's share price will likely be volatile in the short term. But we believe the company is well positioned to deliver outperformance over at least the next several years.

- **Mesa Laboratories, Inc. (MLAB)** designs and manufactures instruments and disposable products utilized in the healthcare, pharmaceutical, food, beverage, medical device, and petrochemical industries. Its major product groups include sterilization indicators; temperature, humidity and pressure data loggers; cold chain monitoring systems; and thermal packaging products. MLAB outperformed in 4Q18 after a strong quarter characterized by significant margin expansion. More importantly, these results may indicate that the new management team is gaining traction in its efforts to optimize MLAB's business and rejuvenate its growth. As the new management team continues to transform the company, we expect MLAB to see significant growth from both organic sources as well as through strategic acquisitions.

- **EVERTEC, Inc. (EVTC)** provides payment processing, merchant acquisition and business solutions to customers in Puerto Rico and Latin America. Its shares outperformed in 4Q after the company reported strong 3Q18 results which indicated that rebuilding efforts and economic recovery in Puerto Rico after the 2017 hurricanes were well underway. We believe the recovery will last a few years as insurance recoveries and government aid continue to make their way into the local economy. This positive economic backdrop, combined with a modest valuation, helped EVTC's stock to outperform. As EVTC's stock continues to appreciate, we will re-evaluate our position accordingly.

The top three detractors during 4Q were:

- **Tyler Technologies (TYL),** a provider of software to state and local governments, reported weak organic growth and bookings figures in the 4Q. In addition, management commented that growth investments will impact margin expansion yet again in 2019. On the positive side, TYL reported in-line 3Q EPS, reiterated 2018 EPS targets, and resumed its stock buyback program. TYL continues to have a rock-solid balance sheet, and we suspect that management has recently accelerated buybacks with the stock's retreat. Given our belief that the weak 3Q revenue and bookings results were more a hiccup than a trend, management's strong history of value-additive buybacks, and a more favorable valuation, we added to our position in the quarter.

- **John Bean Technologies (JBT)** is a leading manufacturer of food and beverage processing equipment, as well as airport ground equipment. JBT stock performed poorly in 4Q after the company reported disappointing results for 3Q and lowered its full year outlook. Both revenue growth and profit margin expansion were below expectations, as the company cited market uncertainty related to trade issues and delays in customer orders and shipments. Higher material costs and shipping costs also created headwinds in the quarter. But we believe the company's long-term story of optimization and transformation remains. The company has the right management team to create substantial shareholder value over time.

- **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 will contribute significant revenue and growth to TECH.

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 buying and selling 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.

*****

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.