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DF Dent All Cap Growth Strategy

April 2019 Commentary

The S&P 500's 13.65% gain for the first quarter was its best quarterly gain in nearly a decade and its best start to the year since 1998. U.S. equities bounced back after the fourth quarter's 13.52% decline, led by a dovish Fed and increasing optimism on a trade deal with China. The U.S. economy is in good shape as evidenced by solid economic growth and a labor market that remains resilient.

Portfolio Thoughts

	1Q19	YTD 2019
All Cap Growth (gross)	20.36%	20.36%
All Cap Growth (net)	20.20%	20.20%
Russell 3000 Growth Index	16.18%	16.18%

For the first quarter of 2019, D.F. Dent’s All Cap Growth strategy outperformed the Russell 3000 Growth Index. The strength was driven by solid earnings reports across the portfolio. 77% of D.F. Dent portfolio companies beat Wall Street earnings expectations during the quarter. The S&P 500 saw 70% of its companies exceed estimates. The strategy’s outperformance was fairly broad. Sectors where stock selection positively impacted the portfolio included the Health Care, Industrial, Financial, Real Estate and Materials sectors. The positive stock selection was slightly offset by unfavorable stock selection in the Technology sector.

The All Cap Growth strategy added one name to the portfolio in the first quarter, Vulcan Materials. The strategy exited six names in the first quarter - A.O. Smith Corp, Celgene Corp, Core Labs, LKQ Corp, Transunion and WageWorks Inc. The All Cap Growth strategy ended the first quarter with 39 names.

New Additions to the Portfolio:

- **Vulcan Materials (VMC)** is the leading provider of construction aggregates in the United States. While Vulcan is not one of the fastest growing companies in the portfolio, it is one of its best businesses. Rock has been used for construction for millennia, no substitutes are practical on a large scale, and the business faces almost zero obsolescence risk. Vulcan has formidable “moats” and pricing power resulting from the difficulty of permitting new quarries, its strategically-located footprint in high-growth areas, the high weight-to-value ratio of rock (making transportation expensive), and a consolidating industry. While we are cognizant of cyclical risks, we expect Vulcan to generate an above-market total return from solid organic growth via volume and pricing gains, strong margin expansion, and disciplined capital allocation.

Positions Exited in the Portfolio:

- **A.O. Smith Corp. (AOS)** is a leading manufacturer of residential and commercial water heaters. AOS has a dominant U.S. franchise for which we have a very high regard. We eliminated the position, however, after becoming increasingly uncomfortable with AOS' Chinese exposure, which should account for approximately half of AOS' expected earnings growth by 2020. Given the Chinese market's reliance on new housing demand, economic stimulus, and distribution channel dynamics that favor ecommerce over brick and mortar, we lost confidence that AOS could meet our earnings growth objectives and/or regain its historic premium valuation.

- **Celgene Corp (CELG)** is a biopharmaceutical company engaged in the discovery and commercialization of therapies for cancer and inflammatory diseases. Recognizing the value in Celgene, Bristol-Myers Squibb offered to acquire Celgene in a deal that values Celgene at approximately $97/share plus an incremental $9/share in potential future milestone payments. When CELG's price appreciated to the low-to-mid $90's, fairly close to the deal price (excluding milestone payments) and no longer offering an attractive risk-reward profile, we elected to sell our position.

- **Core Laboratories NV (CLB)** is a leading energy services company offering reservoir description and production enhancement services. Over the last year, CLB's earnings growth has slowed as lagging international and deepwater oil development activity, constrained pipeline capacity in the U.S. Permian Basin, and weak oil prices in late 2018 all dragged on results. While global oil prices have recovered off the bottom and Permian pipeline bottlenecks could abate later this year, we see significant risk factors facing the company. These include continued efficiency gains from US shale producers or a slowing global economy, both of which would pressure oil prices and curtail demand for CLB's solutions. Despite being a best-in-class company in the industry, given these concerns we exited our small position.

- **LKQ Corp. (LKQ)** is a leading provider of recycled, aftermarket, and other automotive parts. We elected to exit our position following several years of weaker-than-anticipated financial performance that we expect will continue. We had become increasingly skeptical of the company's acquisition-intensive growth strategy and were disturbed by the company's inability to foresee developments in its industry. We have also become more cognizant of the multitude of industry forces that heavily impact LKQ's pricing power but are beyond the company's control. Given our reduced conviction in LKQ's future growth trajectory, we eliminated our position following the stock's early 2019 rebound.

- **TransUnion (TRU)** is a leading information services company with advantaged, legacy credit bureau assets. We had done extensive due diligence into TRU over two years before buying the name in 2018. We had met with upper management, spoken with customers, visited TRU's headquarters, and met with a competitor, and engaged in product demonstrations. After attending TRU's first investor day early this year, however, and meeting with additional business unit leaders, our conviction in TRU's return potential was somewhat lessened. We exited the position as a result.

- **WageWorks (WAGE**) is an administrator of consumer-directed benefit accounts for employers. WAGE has been under scrutiny for issues stemming from its delayed 2017 10-K filing. WAGE and its auditors continued to review the company's financial statements and its revenue recognition policies. While we believe WAGE is largely past its accounting issues, we had lost confidence in the previous management team and did not believe that the new management team had righted the ship. In addition, our projected revenue and EPS growth rates for WAGE have declined over the past 6 months, reducing our expected return to levels we found unattractive.

Ticker	1Q19	Contribution To Return
	5 Largest Contributors	**4.67**
V	Visa Inc. Class A	1.14
SPGI	S&P Global, Inc.	0.89
ECL	Ecolab Inc.	0.88
TDG	TransDigm Group Incorporated	0.87
ROP	Roper Technologies, Inc.	0.87
	5 Largest Detractors	**-0.02**
HCSG	Healthcare Services Group, Inc.	-0.29
MKL	Markel Corporation	-0.03
ILMN	Illumina, Inc.	0.07
TRU	TransUnion	0.10
QLYS	Qualys, Inc.	0.13

The top three contributors during 1Q were:

- **Visa, Inc. (V),** the world's largest electronic payment network, reported fiscal first quarter results that were modestly above market expectations for both net revenues and earnings per share. The steady, global transition from cash and check to digital forms of payment continues, aided by the growth of e-commerce. Opportunities are also materializing in new markets such as business-to-business and peer-to-peer payments. We believe these digital payment tailwinds, coupled with excellent management execution and a market-leading position in a global oligopoly, make Visa an attractive long-term investment.

- **S&P Global, Inc. (SPGI)**, a leader in providing ratings, benchmarks, analytics, and data to the capital and commodity markets worldwide, reported a 4Q that showed strong cost control. While revenues were down 3% year over year and shy of estimates due to weakness in the ratings business, earnings met the low end of expectations due to superb cost control and strength in other divisions. Earnings grew 20% in the quarter and 23% for the year. While the ratings business is expected to continue to lag in the near-term, other divisions of the company are performing well and management continues to deliver improving margins across the board. We continue to see SPGI as a low-to-mid double-digit EPS grower and view it as a core holding.

- **Ecolab (ECL**), a provider of chemistry-based hygiene, water, and energy-related technologies, modestly outperformed in 1Q19. ECL reported generally in-line earnings and guidance figures, announced the spin-off of its downstream energy business (expected in 2020), and increased the estimated savings from its ongoing efficiency initiative. Investors were encouraged by all of the above and are optimistic that Ecolab's growth will be more consistent following the upstream energy spin-off. We continue to see ECL as a strong business with a sticky customer base and economically resilient end markets. We view ECL as a core position.

The top three detractors during 1Q were:

- **Healthcare Services Group, Inc. (HCSG)** provides housekeeping, laundry and dietary services to long-term care facilities. HCSG traded off in 1Q19 because it issued weak 4Q18 results and provided a mixed outlook for 1Q19, to a large extent as a result of the financial difficulties of some of its customers. In addition, the company received an SEC inquiry regarding the company's rounding practices used in its EPS calculation. However, we believe the long-term outlook of this business has not changed, and most of the headwinds the company is facing will prove to be transitory. We believe HCSG can achieve its gross margin goal of 14% within the first half of 2019 and its revenue growth will start to re-accelerate in the second half of 2019. In addition, weak share price performance has made the stock's valuation much more reasonable relative to its own historical multiples. We continue to hold our positions in HCSG and believe the future risk-reward profile is attractive.

- **Markel Corp (MKL)** is a holding company with insurance and investment operations. MKL underperformed after reporting disappointing 4Q results which were impacted by several headwinds, most of which we believe will pass. First, MKL reported an unusually high combined ratio (a measure of insurance-related expenses) due to the abundance of 4Q catastrophes. Second, MKL announced a sizable impairment charge related to a recent acquisition as a result of both high catastrophe volume and a major personnel issue. Third, the Markel Ventures private investment arm closed out a noisy year with results that, on the surface, appeared disappointing. Lastly, depreciation in MKL's equity investment portfolio during the 4Q market swoon reduced the company's year-end book value per share. Believing that most of the above headwinds will pass shortly, we increased our MKL positions in the quarter.

- **Illumina, Inc. (ILMN)** is a leader in sequencing and array-based solutions for genomic analysis. We believe the stock is going through a "resting period" after a substantial period of outperformance. We trimmed the ILMN position several quarters ago, on the basis that significant multiple expansion had resulted in the stock's valuation getting ahead of its earnings growth. Longer term, we continue to believe strongly in ILMN's growth prospects. The applications for ILMN's technology are still in an early stage, particularly in clinical markets. The total addressable market (TAM) will continue to expand as more applications are discovered for genomic sequencing. Given our strong conviction in ILMN's long-term prospects, we are comfortable owning ILMN despite its valuation.

Market Thoughts

We have often commented that liquidity is the lifeblood of the markets. Last fall the Federal Reserve indicated a policy of raising interest rates and shrinking its balance sheet. We believe this contributed to the sharp decline in the stock market in the fourth quarter.

At the end of the year, in the face of trade tensions and the government shutdown, the Fed reversed course and indicated it would not be increasing interest rates in the immediate future and would be considering a temporary halt in the planned reduction of its balance sheet. At the same time the European Central Bank indicated it would hold interest rates at current levels at least through the end of the year. We believe these accommodative moves contributed to the strong equity performance in the first quarter.

So where do we go from here? Given the recent economic slowing in both the United States and abroad, we believe that the Fed and other central banks are going to take a more cautious near-term stance and err on the side of being accommodative rather than restrictive. Currently, the Fed does not expect to raise interest rates this year (always subject to change) and plans to stop shrinking its balance sheet by the fall. Therefore, overall liquidity should not pose a headwind to financial markets for the foreseeable future.

But what about the slowing economy? Absent a Black Swan event, we see little to suggest that a recession is imminent. Few cyclical areas of the economy are meaningfully overextended. Recessions are rarely sparked when the Fed is in a neutral or accommodative position. The rising Chinese stock market bodes well for an improving Chinese economy, which should help Europe and emerging economies. We believe the current soft patch will pass and that economies worldwide should show improved growth. While some of this news is likely discounted in the strong first quarter equity performance, improved economies should provide further support for financial assets. Stocks with good earnings results should continue to reward investors albeit at a much slower rate than in the recent past.

As economies recover, attention at some point will return to the possibility of less accommodative Fed policy. With unemployment low and wages rising, inflation should tick upward absent strong productivity gains. This should eventually force the Fed's hand toward tightening and could spark an eventual recession. Together with political uncertainty as the 2020 election approaches, we could have a recipe for increased market turbulence.

Longer-term, we continue to expect equity returns to be more measured over the next decade. We believe the catalysts of above-trend equity returns since the early 1980s- falling interest rates, rising corporate profit margins, increased debt leverage, and falling tax rates- are largely tapped out and have some risk of retracing their steps. With the tide less in investors' favor, stock selection will be critical. We continue our focus on owning high-quality, "deep moat" companies with proven business models, strong pricing power, and talented and ethical management teams. We see this strategy driving strong long-term returns in a lower-return environment.

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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.