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DF Dent Midcap 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
Midcap Growth (gross)	19.40%	19.40%
Midcap Growth (net)	19.23%	19.23%
Russell Midcap Growth Index	19.62%	19.62%

For the first quarter of 2019, D.F. Dent's Midcap Growth strategy slightly underperformed the Russell Midcap Growth Index. The underperformance came in January followed by outperformance in February and March but not quite enough to outperform for the full quarter. In the quarter, the underperformance was led by stock selection in the Technology sector, particularly the underweight in semiconductors. That was offset slightly by strong stock selection in the Industrials sector. The Midcap Growth strategy exited two names in the first quarter, A.O. Smith Corp. and LKQ Corp. The strategy added one name to the portfolio, Vulcan Materials in the first quarter. The Midcap Growth strategy ended the first quarter with 33 names in the portfolio.

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 which we have a very high regard for. 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.

- **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.

Ticker	1Q19	Contribution To Return
	5 Largest Contributors	**5.49**
TECH	Bio-Techne Corporation	1.14
VRSK	Verisk Analytics Inc	1.13
CSGP	CoStar Group, Inc.	1.11
TDG	TransDigm Group Incorporated	1.06
PRO	PROS Holdings, Inc.	1.05
	5 Largest Detractors	**-0.04**
HCSG	Healthcare Services Group, Inc.	-0.46
MKL	Markel Corporation	-0.06
ILMN	Illumina, Inc.	0.1
QLYS	Qualys, Inc.	0.17
AOS	A. O. Smith Corporation	0.21

The top three contributors during 1Q were:

- **Bio-Techne Corp. (TECH)**, designs and manufacturers best-in-class reagents and instruments for the life science research and clinical diagnostics markets. The stock outperformed due to a strong 4Q18 earnings report, supported by healthy performance in most of its business segments. In addition, management provided 2019 outlook indicating the current strong business momentum will likely continue. TECH has a healthy balance sheet and may continue to supplement strong organic growth with acquisitions with good strategic fit. We believe over time the company's organic growth will likely accelerate further and margins will expand.

- **Verisk Analytics (VRSK)**, a provider of contributory databases and other solutions to the insurance, energy, and banking industries, outperformed slightly after reporting a positive 2019 outlook and instituting a dividend. Given our large VRSK position and the market's strong appreciation, however, VRSK was one of the largest contributors to the strategy's absolute performance. VRSK’s revenue growth has rebounded nicely over the last eighteen months after a slowdown in 2016 and early 2017 caused by energy industry weakness, FX issues, and some other one-time issues. Having trimmed the stock on strength twice in late 2018, we have maintained our positions in 2019. We continue to see VRSK as one of the best businesses in the portfolio, with strong moats, a sticky customer base, and economic resilience.

- **CoStar Group, Inc. (CSGP)**, the leading provider of information, analytics and marketing services to the commercial real estate market, reported fourth quarter earnings per share that handily exceeded expectations and provided annual guidance that was modestly above consensus estimates and could be viewed as conservative. Management also unveiled new 2023 targets that call for growth continuing at near the current levels over the next five years. Management’s targets were that CoStar should be able to grow EPS 20%-25% long term. We believe the official targets should give the market added confidence in the opportunity over the next few years and beyond.

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.