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DF Dent All Cap Growth Strategy

July 2019 Commentary

U.S. equities had a strong second quarter with the S&P 500 index gaining 4.3%. The index's first half return of 18.5% represented the strongest 1H since 1997 and led all asset classes amidst slowing global growth. This year's rebound from the weak fourth quarter of 2018 has been better than we expected, aided in part by generally solid corporate earnings and the Federal Reserve's pivot to a more accommodative stance.

Portfolio Thoughts

	2Q19	YTD 2019
All Cap Growth (gross)	10.21%	32.65%
All Cap Growth (net)	10.08%	32.32%
Russell 3000 Growth Index	4.50%	21.41%

For the second quarter of 2019, D.F. Dent's All Cap Growth strategy outperformed the Russell 3000 Growth Index. The strategy's outperformance was due to strong stock selection and was fairly broad-based. Sectors where stock selection positively impacted the portfolio included the Technology, Health Care, Industrial, Consumer Discretionary and Materials sectors. The positive stock selection was slightly offset by unfavorable stock selection in the Communication Services sector.

The All Cap Growth strategy did not add any new names during the quarter. We continue to find well run companies that fit our criteria and are waiting for more attractive valuations to purchase them. We prefer to be patient and wait for compelling buying opportunities. The strategy exited two names in the first quarter – Blackbaud, Inc. and SEI Investments Company. The All Cap Growth strategy ended the second quarter with 37 names in the portfolio.

Positions Exited in the Portfolio:

- **Blackbaud, Inc. (BLKB)** sells software solutions to non-profit organizations. With its roots in fundraising, BLKB has expanded its offerings into adjacent areas, mostly via acquisition. We sold the stock, after a four-year-plus ownership period, for several reasons: (1) BLKB's steep valuation seems to discount a dramatic, near-term acceleration in organic revenue growth, which we lack high conviction in, (2) we received disappointing feedback from numerous customers regarding BLKB's product quality and customer service, (3) we sense that BLKB's markets may be getting more competitive, and (4) meaningful recent stock sales by senior executives, around current prices, reduce our confidence. While we trimmed the position at much higher levels in November of 2018, we regret that we did not have the foresight to sell all of our position at that time. We were able to redeploy the capital into higher conviction names this quarter.

- **SEI Investments Company (SEIC)** provides technology, manager-of-manager and fiduciary solutions, and related offerings to banks, investment advisors, investment managers, and others. We sold our position after seven years of ownership in order to fund other ideas from which we expect higher returns. During our holding period, we developed great respect for SEIC's management team. We similarly are drawn to SEIC's focus on serving clients and long-term approach toward its businesses. Despite these positives, we sold our SEIC position to fund additions to competing investment ideas that we believe offered more favorable long-term prospects.

Ticker	2Q19	Contribution To Return
	5 Largest Contributors	**3.58**
PRO	PROS Holdings, Inc.	1.03
V	Visa Inc. Class A	0.71
KMX	CarMax, Inc.	0.64
OKTA	Okta, Inc. Class A	0.62
BRKS	Brooks Automation, Inc.	0.58
	5 Largest Detractors	**-0.40**
GOOG	Alphabet Inc. Class C	-0.24
ISRG	Intuitive Surgical, Inc.	-0.12
HCSG	Healthcare Services Group, Inc.	-0.09
BLKB	Blackbaud, Inc.	0.00
QLYS	Qualys, Inc.	0.05

The top three contributors during 2Q19 were:

- **PROS Holdings, Inc. (PRO)**, a leading provider of pricing software and B-to-B e-commerce solutions, reported strong 1Q19 results and increased most guidance metrics for the year. The meaningful guidance increases, unexpected so early in the year, were due to strong bookings activity and earlier-than-expected "go-lives" of several new relationships. PRO continues to benefit from rapid growth in data-driven and dynamic corporate pricing strategies, rapid growth in B-to-B e-commerce, and increased partner-driven sales of PRO products. We attended PRO's Outperform customer conference in Las Vegas in May and, there and separately, received generally favorable customer feedback. We continue to be bullish about the company's prospects. Given the recent multiple expansion, however, we trimmed our position during 2Q19.

- **Visa, Inc. (V),** the world's largest electronic payment network, reported fiscal second quarter results that were largely in line with market expectations. 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 and underpenetrated geographies such as India and parts of Europe. 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.

- **CarMax, Inc. (KMX),** the leading used car retailer in the U.S., reported strong first quarter results for FY20, delivering the highest quarterly same-store-sales growth in the last five years. For the prior few quarters, used car prices had been elevated, making used cars less attractive relative to new cars. That dynamic started to reverse in the first quarter. Attractive used car pricing, a favorable auto lending environment, and CarMax's improved omni-channel experience drove strong revenue and profitability growth. Favorable industry factors along with continued rollout of the omni-channel experience to other major markets should help KMX sustain strong sales growth in the intermediate term. Longer term, we believe KMX's superior customer experience offering, data analytics, and scale advantages should sustain its leadership position and drive market share gains. Given the recent multiple expansion, however, we trimmed our position during 2Q19.

The top three detractors during 2Q19 were:

- **Alphabet, Inc. (GOOG),** a global information technology company, has dominant positions in many of the most popular internet applications. GOOG underperformed our portfolio in 2Q19 because the company reported weak 1Q revenue growth. However, the slowdown represented a proactive choice by management as it was caused by the company's improving the quality and suitability of content served on YouTube. This move improves customer experience and should bring healthier growth to the business over time. Another factor negatively impacting GOOG's stock is potential regulatory risks as some politicians are calling for the breakup of the company. We don't believe reasonable regulation will pose meaningful long-term challenges for GOOG's business and a breakup (unlikely) may actually benefit shareholders by unlocking the value of GOOG's various business subsidiaries.

- **Intuitive Surgical, Inc. (ISRG)** is the leader in the design and manufacture of surgical robotic systems. ISRG stock underperformed our portfolio in 2Q19 because the company missed consensus 1Q earnings estimates due to higher discretionary spending. We believe the market's reaction was short-sighted, however. It seemed to ignore ISRG's very strong business fundamentals, led by 18% year-over-year global procedure growth. We also believe the spending increase is the right strategic move as the company aggressively expands its technology lead before potential competitors come to the market. ISRG continues to be a high quality business with ample room for growth. We believe the stock will outperform the market over time and added to our position in the quarter.

- **Healthcare Services Group, Inc. (HCSG)** provides housekeeping, laundry, and dietary services to long-term care facilities. Its stock struggled in 2Q19 as the company reported a disappointing quarter with weak revenue growth and accounts receivable reserve bookings. This was caused by financial difficulties at some of HCSG's customers. However, we believe the worst is likely over for HCSG's business as the company has already achieved its gross margin target of 14% and has put in place resources needed to return to higher revenue growth going forward. Most of HCSG's largest customers have gone through financial restructuring, reducing the risk of significant additional reserve bookings. Meanwhile, HCSG has no debt and pays a 2.6% dividend yield that is sustainable.

Notes From The Road

At D.F. Dent, we spend significant time traveling to visit companies and to meet with management teams. These trips are vital to our research process given our emphasis on finding ethical and talented management teams running high quality businesses. Going to company headquarters helps us determine if a management team is exceptional. These visits allow us to observe how they operate, interact with their team, treat employees, and think about growth opportunities.

We recently had a team of portfolio managers and analysts travel to visit two companies. They saw two very different companies managed by very different types of leaders. Company A has a strong core product that is essentially a monopoly. The company also has significant momentum in new products which expand its market and should lead to a larger, more stable, and more profitable business over time. While we have a generally favorable view of the business, we are less impressed with management. We believe management's strategy and recent execution have been sound, but we have concerns related to ego, aggressiveness, and lack of frugality. In addition to concerns around valuation, these misgivings reduce our confidence in the stock and, as such, we have opted to pass on investing in the company.

Company B has slower growth than Company A, but we believe it is an excellent business with a wide moat. There is a secular tailwind to the business and significant share gain potential, which we believe should lead to steady, repeatable growth for many years. And importantly, the favorable view of management we have developed throughout our research was reinforced in our meeting. Management articulates a clear strategy, and their operational expertise and execution have been commendable. We are also impressed by their humility and cultivation of a strong corporate culture. They are the type of people we would be proud to tell our clients that we have entrusted with their money. This seems to be a clear D.F. Dent company, and our only question is whether current valuation offers a sufficient risk-adjusted expected return.

These road trips are valuable because they allow us visit companies and see managements in person. It is a continuous process of critical thinking comparing our existing portfolio names to companies we don't own. The result is a portfolio of high quality growth companies run by excellent management teams, which we believe will outperform the general market over the long term.

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D.F. Dent was favorably mentioned in the July 6th edition of Barron's in an article by Daren Fonda.

We were pleased to welcome Chris Gryniewicz to the firm in May as an Associate Analyst. Chris has earned his CFA and has six years of investment experience, having previously served as a senior equity research associate at Manning & Napier. We have been impressed by Chris's capabilities and look forward to his contributions in the years ahead.

We appreciate the confidence you have placed in D.F. Dent and Co. and will continue to work diligently on your behalf.