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DF Dent Small Cap Growth Strategy

January 2020 Commentary

U.S. equities posted strong returns during the fourth quarter of 2019. The S&P 500 gained 9.1% in the quarter, which helped bring the full year to a 31.5% gain. Growth outperformed value for the quarter and the year. Strong 4Q equity returns were due in part to an accommodative Fed and an announcement of a "phase one" trade deal between the U.S. and China. The trade deal will lower some U.S. tariffs on Chinese goods while boosting Chinese purchases of manufactured goods, agricultural goods and energy. The combination of improved sentiment and the fear of missing a year-end rally drove equity appreciation.

Portfolio Thoughts

	4Q19	2019
Small Cap Growth (gross)	8.6%	37.8%
Small Cap Growth (net)	8.5%	37.1%
Russell 2000 Growth Index	11.4%	28.5%

For the fourth quarter of 2019, D.F. Dent's Small Cap Growth strategy underperformed the Russell 2000 Growth Index. Stock selection in the Consumer Discretionary and Healthcare sectors accounted for most of the underperformance. In Consumer Discretionary, the portfolio experienced some stock-specific headwinds in the quarter. In Healthcare, not owning biotech and pharmaceutical stocks hurt performance. D.F. Dent has avoided investing in businesses in biotech and small cap pharma since they are too dependent on binary outcomes like FDA actions of unproven products. For these reasons, being underweight healthcare versus the benchmark also impacted performance. This was slightly offset by strong stock selection in the Communication Services, Financials, and Technology sectors.

For the year, the Small Cap Growth strategy outperformed the benchmark. Strong stock selection was broad-based across most sectors, but stood out in the Technology, Financials, Industrials, Communication Services and Consumer Discretionary sectors. Growth strategies dominated the equity markets in 2019 at the expense of cyclicals and value investing. Companies with cutting edge engineering, software, and research were the standouts whether those skills were applied to health care, technology, or even consumer services. This appears to be a very pervasive trend as innovative companies with disruptive technological advances expand their own markets. To benefit from this trend, we seek to identify companies benefitting from a "virtual fly wheel effect" early in their lifecycles.

The Small Cap Growth strategy added two new names during the quarter: Floor & Decor and OneSpaWorld. The strategy exited four names in the fourth quarter: Genesee & Wyoming, Healthcare Services Group, Vapotherm, and Watsco. The Small Cap Growth strategy ended the quarter with 46 names.

New Positions in the Portfolio:

- **Floor & Decor (FND)** is a retailer of hard surface flooring and related accessories with 113 warehouse-format stores in 28 states. FND's strategy is to offer consumers the broadest selection of in-stock inventory at the lowest available prices. In our view, the key sources of sustainable competitive advantage are focus, scale, and operational expertise. Led by a talented management team with prior experience at Home Depot and other retailers, we believe FND will continue to execute on its goal of growing its store count 20% per year over the medium term and to 400+ stores longer term. We believe the company can continue to grow its revenue at a high-teens rate and EPS at a mid-20% level longer term.

- **OneSpaWorld (OSW)** provides outsourced health and wellness services onboard cruise ships. OSW's model is asset-light with contracts structured as revenue-sharing agreements with minimal capital requirements (~1% of sales). The company dominates the space with over 90% share and have agreements with all the major cruise lines. These relationships are long, often ranging 10+ years. Going forward, we expect OSW will benefit from industry capacity additions as all of the major cruise lines are adding ships. Coupled with balance sheet deleveraging, we anticipate EPS will grow at a mid-teens rate over the next five years.

Positions Exited in the Portfolio:

- **Genesee & Wyoming (GWR)**, the leading short-line railroad operator and consolidator, entered an agreement to be acquired by Brookfield Infrastructure and GIC in a transaction that valued the enterprise at $8.4 billion, or $112 per share in cash. This acquisition price was attractive and represented an unlevered free cash flow yield of ~5% on our 2019 estimates which, in turn, may have been based on volumes that were near a cyclical peak.

- **Healthcare Services Group (HCSG)** provides housekeeping, laundry and dietary services to long-term care facilities. HCSG shares continued to underperform in the quarter because the company continues to suffer from some customers experiencing financial difficulties, and HCSG had to walk away from some business. Our long-term view on the quality of HCSG's business significantly changed for the worse and our confidence in management's credibility also diminished.

- **Vapotherm (VAPO)**, is a medical device manufacturer with an innovative, non-invasive oxygen delivery system for patients suffering from respiratory distress. We decided to exit our position following multiple quarters of disappointing capital equipment sales. Our concern is that the primary issue is not salesforce disruption, which the company acknowledges, but a more general lack of demand pull from hospital buyers. We believe issues related to market education and the company's selling model will take time to fix. Given the company's lack of profitability and the slowing progress, we worry our equity, had we continued to hold the shares, would be diluted meaningfully before the company was either acquired by a strategic or became self-funding.

- **Watsco, Inc. (WSO)**, is a distributor of air conditioning, heating and refrigeration equipment. While we continue to like some aspects of WSO's business, we are becoming increasingly concerned that the money WSO is spending on technology will not lead to market share gains but is required to simply "tread water." We also worry that we are on the other side of the housing "echo boom," which we believe is beginning to dampen results and could continue to be a drag for the intermediate future. Those concerns, coupled with a recent rebound in the share price, led us to exit the position.

Ticker	4Q19	Contribution To Return
	5 Largest Contributors	**3.69**
DXCM	DexCom, Inc.	0.92
PLOW	Douglas Dynamics, Inc.	0.84
SITE	SiteOne Landscape Supply, Inc.	0.70
TRUP	Trupanion, Inc.	0.64
KIDS	OrthoPediatrics Corp.	0.59
	5 Largest Detractors	**-1.08**
W	Wayfair, Inc. Class A	-0.47
HEI.A	HEICO Corporation Class A	-0.24
EVOP	EVO Payments, Inc. Class A	-0.17
MIDD	Middleby Corporation	-0.10
CMD	Cantel Medical Corp.	-0.10

The top three contributors during 4Q19 were:

- **DexCom, Inc. (DXCM)**, a pioneer and leader in continuous glucose monitoring (CGM) technologies for the management of diabetes, performed well in the quarter as the company reported exceptionally strong results for 3Q and increased full-year guidance. In addition, 2020 and 2021 are setting up to be very good years for DXCM with growth opportunities from pharmacy channel expansion, launches for Medicare patients, and international expansion. We believe DXCM will continue its rapid growth and leadership in the diabetes care market in the foreseeable future. We trimmed the position in the quarter based on elevated valuation.

- **Douglas Dynamics (PLOW)**, the leading manufacturer of snow plows and ice control truck attachments in North America and a leading upfitter of commercial work trucks, continued to outperform as the company reported solid 3Q results and provided relatively upbeat commentary. The chassis supply issues that have plagued PLOW and the rest of the industry in recent years seem to be improving, which should provide a further tailwind to PLOW's results in 2020. We continue to like PLOW's management team, the company's competitive positioning in its legacy Work Truck Attachments segment, and the long term growth opportunity in the Work Truck Solutions segment via greenfield expansion and M&A.

- **SiteOne Landscape Supply, Inc. (SITE)**, the only national distributor of landscaping products, outperformed in the quarter due to strong 3Q earnings that combined robust organic growth, margin expansion, debt reduction and a very active acquisition pipeline. These results demonstrated to the market that SITE's business model and long-term strategies are working as intended. We continue to like SITE as an investment and believe it is a compounder that will significantly outperform the market over the long-term. We trimmed our position during the quarter.

The top three detractors during 4Q19 were:

- **Wayfair (W)**, a leading online furniture and home goods platform, reported mixed 3Q results with better than expected revenue growth but lower profitability. The stock sold off post earnings due to weaker than expected guidance, which pointed to decelerating revenue growth due to tariffs. The tariffs have led to some pricing volatility for goods listed on Wayfair's platform, which has lengthened the customer decision making process and lowered conversion. We believe this is a short-term headwind, which is likely to dissipate over the next several quarters. Traffic to Wayfair's website and apps remains strong. We are also optimistic that Wayfair's EBITDA and gross margins will start improving in the second half of 2020. We continue to like Wayfair's owner-operator management team, its expanding moat, and its long growth runway supported by secular tailwinds. We added to the position in the quarter.

- **HEICO Corp. (HEI.A),** a designer and manufacturer of products for the aerospace, defense and electronics markets, underperformed in the quarter after it reported fiscal 4Q results and provided guidance for fiscal 2020. Despite healthy fiscal 4Q results that easily beat consensus estimates, the company provided 2020 guidance that was viewed as weak on organic growth, particularly for its Electronic Technology Group (ETG) segment. However, we believe part of the "weak" guidance is due to the natural lumpiness of its business (particularly the ETG segment) and part of it is due to management's conservatism. We remain confident in HEI.A's fundamentals, and we continue to believe this company is an excellent long-term investment.

- **EVO Payments (EVOP)**, a global merchant acquirer and payment processor, underperformed in the quarter, though little has changed in our long-term outlook for the company. 3Q results were generally in line with expectations and the company maintained its full-year guidance. However, revenue growth has been below management's long-term expectations in 2019 as the company has faced headwinds related the acquisition of two bank referral partners in Europe, which has pressured valuation. In addition, the market has absorbed an increase in supply of shares in the public float as the company's PE sponsor continues to wind down its position, as planned. We visited EVOP's headquarters during the quarter and we remain confident in management's strategy and the company's long-term growth potential. We added to our position in the quarter.

<u>Market Thoughts</u>

At the beginning of each year, strategists attempt to forecast the market. Like weather forecasts, they are extremely variable, often wrong, and are not reliable. So we refrain from trying to predict where the stock market will close at year end. We do believe that we will see a very different environment in 2020 than we did in 2019. Last year, the market delivered modest earnings' growth but significant expansion of price to earnings multiples thanks to a more accommodative interest rate environment. We also experienced a steadily increasing stock market with very low volatility (there was not even one 10% correction). This year, we expect limited multiple expansion and much greater volatility.

Aside from the usual concerns about economic growth, corporate profits, trade, etc., we believe there are two other factors which will weigh heavily on investors' psyches. First, the political environment that will emerge at the end of the year will be one of two scenarios. A continued divided government will comfort a lot of investors as it will mean a low probability of major structural reforms. On the other hand, a unified progressive government will likely mean higher taxes (corporate, individual and capital gains) which might unnerve some investors. We have no strong opinion on what the outcome will be at this point. Second is the outlook for inflation. Inflation is below the Fed's target and has been surprisingly low given the 50 year low in the current unemployment rate. Many economists thought low unemployment would have led to sharply higher wages by now, but that has not been the case. Should this positive scenario continue, the Fed will likely remain accommodative. Add to that rising corporate profits, and the market could experience another nice move to the upside. On the other hand, if inflation starts to accelerate at a faster pace than the

Fed expects, the Fed might reconsider its current accommodative policy. Fears of a change in policy would not be welcomed by the market (remember the fourth quarter of 2018).

Volatility can be the investor's friend since it can provide good opportunities to add to stocks under pressure and trim stocks benefitting without reason. We expect 2020 to offer plenty of opportunities. At D.F. Dent, we are focused on the businesses that make up the portfolio. We will remain vigilant for opportunities to take advantage of the market volatility.

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