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D.F. Dent All Cap Growth Strategy

April 2021 Commentary

During the first quarter of 2021, U.S. markets lapped the anniversary of the onset of COVID-19. The pandemic shook the economy, rattled investors, and changed our lives, likely for years to come. Nearly fourteen months later, things are looking up as vaccines are becoming widely available, the country is re-opening, the unemployment rate is improving, and expectations for economic growth are robust. Given that backdrop, markets continued a reversal that began in late 2020, with value stocks outperforming their growth counterparts, lower quality prevailing over higher quality, and small cap besting large cap. The secular growth winners of 2020 generally took a pause as investors continued shifting capital to more economically sensitive companies that are expected to benefit from the re-opening. The S&P 500 rose 6.2% while the Russell 3000 Growth Index was up 1.2% compared to 11.9% for its Value counterpart. The move in interest rates for intermediate and long maturities was an important factor for the quarter and one that bears watching as investors digest the potential for rising inflation. The 10-year Treasury rose from 0.93% at year end to 1.74% at the end of the first quarter as expectations for economic growth improved. The quarter marked one of the worst showings for bond markets in decades with bond prices plummeting as yields rose. Despite the substantial move, interest rates remain very low by historic standards.

<u>Portfolio Thoughts</u>

During the quarter, growth stocks lagged their value counterparts and the market was led by sectors and companies where we typically do not invest or are underweight the market. At D.F. Dent, we look for high-quality, best-in class businesses with sustainable growth and talented and ethical management. This means that we typically underweight sectors that are the most economically sensitive, commodity oriented, reliant on government subsidies, or likely to be disproportionately impacted by regulation or other exogenous factors. These types of companies often have less control over their destinies, in our view. Even sectors in which we regularly invest, such as technology, were led this quarter by more commodity and economically sensitive businesses. Within technology, we have significant exposure to software companies, where we have found many businesses that better fit our criteria. Many of our software stocks were large outperformers for 2020; however, some of these stocks took a pause to start 2021.

For the past 46 years, we have operated D.F. Dent with the primary goal of enhancing long-term returns for our clients. We have pursued that objective by creating a durable and repeatable process. We strive to identify and own exceptional growth businesses, and we remain disciplined about owning “D.F. Dent-caliber companies” irrespective of market or macroeconomic conditions. It is easy for managers and clients alike to lose focus on the long term, especially during periods of short-term underperformance or sector or style rotations within the market. Fund managers are often inclined to make decisions that they believe will improve their near-term performance, chasing short-term winners, possibly at the expense of performance over the longer term. We try to avoid falling prey to that behavioral trap.

Exceptional growth companies are not easily replaceable. Your portfolios are made up of companies that we believe are best-in-class, with durable growth and outstanding management teams whom we trust as stewards of your capital. The work we do to analyze a company is long and arduous. There is a high threshold for a stock to make it into your portfolios. Before we invest in a company, we do significant due diligence to understand the industry and the business and to appreciate both the long-term prospects and the risks. Therefore, our bias is to continue to hold these companies, oftentimes using short-term weakness to add to positions, so long as our investment thesis remains intact and valuation remains reasonable. We think of ourselves as owners of businesses, rather than simply owners of stocks that one can easily trade in and out of. We encourage our clients to do the same.

For those of our clients with balanced accounts, our conservative position in fixed income helped portfolios this quarter as the strong move in intermediate and long-term rates resulted in one of the worst quarters in decades for bond markets. The Bloomberg Barclays Government Credit Index returned -4.3%. Given the outlook for interest rates and inflation, which we discuss in more detail below, we are not inclined to increase maturities within our portfolios and continue to believe that a conservative position is prudent.

Market Thoughts

As we look ahead, we believe that the large fiscal and monetary tailwinds of 2020 may continue to carry markets for a bit longer. Economic growth should be strong, bolstered by another round of stimulus. Growth in earnings is expected to follow suit. The massive vaccine roll-out that began in December, coupled with significant ongoing fiscal and monetary stimulus and an abundance of pent-up demand, should help support the reopening of the economy just in time for summer. As a result, the path of least resistance may continue to be upwards for stocks.

However, there are risks on the horizon that could pose a threat to U.S. equity markets. Some nations around the world continue to struggle with COVID-19 outbreaks and have been less successful in implementing vaccine programs. Even within the U.S., cases remain elevated in certain areas despite the availability of vaccines. Meanwhile, the surge in economic growth may prompt a rise in inflation expectations and interest rates. Given the low level of absolute rates, a measured rise in interest rates alone is not necessarily enough to disrupt equity markets; however, if it occurs as a result of increased inflation, we may see a reversal of the positive correlation between stock prices and U.S. bond yields that has persisted for over two decades. During that time, inflation posed little risk. As interest rates increased, stock prices did the same because it was a sign of an improving economy and higher real growth. Now, with cyclical and structural forces increasing the risk of inflation over the coming years, the positive correlation could break down. This is similar to what happened in the 1960s and '70s. As the economy grew, the Fed was forced to increase rates in an attempt to keep inflation under control, thus lowering economic growth prospects.

The Federal Reserve may try to keep rates low for an extended period, but the upward pressure on rates may eventually prevail. To the extent that inflation is persistent rather than transitory, we may enter a period of declining equity valuations as interest rates rise. All else equal, higher rates generally result in future cash flows being more heavily discounted, making them worth less today. Companies will need to grow cash flows and earnings at a rate greater than the rate at which multiples contract in order to see stock price appreciation. While we may still be several years away from higher levels of inflation, the market is forward looking and will likely move well in advance.

What does this mean for growth investing? For the past 13 years, the performance disparity that favored investing in growth stocks has been large. Growth investors have had a tailwind that allowed mistakes to be made without severe punishment and for lower quality growth stocks to perform well. That phenomenon may have run its course. However, we continue to believe that investors will be rewarded for investing in true, high-quality growth stocks. Fundamentals and valuation are likely to be more important than ever in this potential new era for growth investing. At D.F. Dent, we have always focused on high-quality growth stocks, while considering the price we pay for that quality. Without the tailwind of multiple expansion, we recognize the need to be even more prudent in our decision making. In the long term, it is our fundamental belief that above-market earnings per share growth is highly correlated with above-market stock price appreciation. We remain confident that our time-tested investment strategy and focus on earnings growth and valuation will continue to reward investors over the long term.

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Here in Baltimore, the first signs of spring have emerged. Flowers are beginning to bloom, grass is turning green, and trees are filling in with leaves. It's a welcome awakening after a cold winter. It feels especially sweet this April, though, as we reflect on the changes, sacrifices, fear, and sadness this past year has brought. We look forward with hope and anticipation. As many on our D.F. Dent team, along with their families and friends, have been vaccinated, and Maryland has recently expanded eligibility to all adults, we are grateful for the possibility of working and being together once again. We especially look forward to seeing our clients again, though the many emails, telephone calls, and Zoom meetings have helped to fill the gaps in the meantime. As always, please feel free to reach out to us with any questions or concerns. We welcome the chance to discuss your portfolios or just to say hello.

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