Looking Forward

Friess Associates market observations and insights

Sept 30, 2017

Talk of a "Stock Picker's Market" Sounds Good

The September quarter was marked by a series of legitimate threats to investor sentiment. Both man and Mother Nature seemed determined to wreak havoc on Americans.

In September, Equifax disclosed that hackers infiltrated its mammoth database of individual identification data, thus injecting something likely to fall between hassle and nightmare into the personal financial futures of 143 million people. The S.E.C., the agency that regulates the stock market and houses its most sensitive information, said it, too, fell victim to hackers.

Three hurricanes in merciless succession battered their way through the Caribbean en route to the southern United States. One of them inundated the country's fifth largest and one of the fastest growing metropolitan areas with a 1,000-year flood. Another storm left in its wake an economically ailing island territory with little infrastructure intact.

On the geopolitical front, war-related rhetoric between the United States and North Korea entered uncharted territory.

The good news is investors don't seem to be worried about matters of macro concern. That's right, confronted with a multiplicity of menace, the stock market in the three months through September was, in a word, subdued. Not quite tranquil. Perhaps orderly.

The CBOE Volatility Index (VIX), commonly known as Wall Street's "fear index," ended September within a whisker of its all-time low. Launched in 1993, the index closed below 10 only four times between 1995 and 2016. In July, it closed in single digits a record 10 days in a row. The index closed out September with three consecutive days in single digits.

What's more, this is not a backward-looking index telling us that the recent past wasn't so bad after all. The VIX uses S&P 500 Index options activity to project volatility expectations 30 days out.

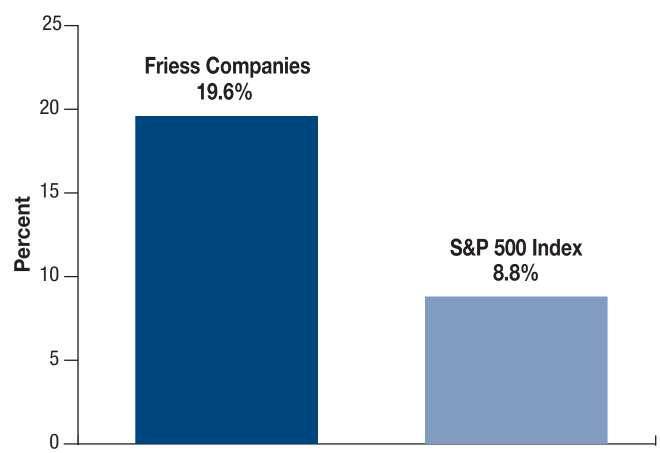
Whether fortuitous timing or somehow intertwined, investors are keeping their cool while at the same time becoming more discriminating in choosing among stocks.

"U.S. equity-market correlations have fallen to the lowest level since 2002, and are likely to stay there as later-stage market cycle dynamics (tightening monetary policy, flattening valuations and steady albeit milder growth) continue to define the immediate outlook," Bloomberg Intelligence wrote in a September 29 report.

In other words, it's a stock picker's market. Okay, they're not really other words since the report was titled "Stockpickers' Market," but we made a couple stylistic changes. Either way, we're stock pickers, and we're encouraged by the increase in selectivity that we continue to witness in the broader market.

That's because the companies we're isolating stand out for their above-average earnings outlooks. Based on consensus estimates, the average company held in Friess-managed portfolios is expected to grow earnings 19.6 percent in 2017. The average company in the S&P 500 Index is expected to grow earnings just 8.8 percent this year.

Estimated Earnings Growth



Forecasted Increase in Earnings Per Share 2017 vs 2016

Source: Consensus estimates from FactSet Research Systems Inc., as of Sept 30, 2017.

This is not a forecast of future performance. Earnings growth for a portfolio holding does not guarantee a corresponding increase in the market value of the holding or the portfolio.

Despite weather-related disruptions that no doubt took place during the third quarter, earnings pre-announcements based on individual-company assessments of their business trends are not out of the ordinary.

According to FactSet Research Systems, 118 companies in the S&P 500 Index issued updated guidance regarding third-quarter earnings. With 64 percent lowering their outlook, the percentage of companies issuing negative earnings guidance is below the five-year average of 75 percent (companies are more apt to get bad news out of the way early). In all, 76 companies lowered guidance, just under the five-year average of 79.

Meanwhile, 42 companies raised third-quarter guidance, which is well above the five-year average of 27. Forty-two companies boosting their outlook ahead of reported earnings represents the fourth highest number since Factset began tracking earnings guidance in 2006.

PRA Health Sciences (page 5) updated its guidance when it reported 25 percent June-quarter earnings growth, exceeding the consensus estimate. PRA is a contract research organization (CRO) that conducts research, primarily clinical trial work, on behalf of pharmaceutical and biotechnology companies. The company is a popular research partner thanks to more than three decades of experience and a database to show for it.

Thanks to strong demand for its comprehensive services, including trial design, patient acquisition, predictive analytics and regulatory affairs, PRA's organic growth rate outpaces growth in the overall CRO market. In addition to contracts related to specific trials, PRA is entered into strategic partnerships, most notably a deal with Takeda Pharmaceuticals that gives PRA full research and development responsibility for Takeda's entire product pipeline.

Global electric car stock topped two million units in 2016 after crossing the one-million unit mark in 2015, according to the International Energy Agency. From local, grassroots efforts to international governmental cooperation, the push to get more electric vehicles is expected to drive exponential growth in the years ahead. We believe Albemarle Corp. (page 4) is in a prime position to benefit from the demand for lithium to fuel the many new batteries that would be needed as a result.

The biggest producer in the market, Albemarle is responsible for more than one-third of overall lithium output. In a business with high barriers to entry, Albemarle's global assets give it an unrivaled ability to manage production capacity. June-quarter results showed the company's lithium sales jumped 55 percent, helped along by a 31 percent increase in pricing.

It's a great time to be in the recreational vehicle business, with the RV Industry Association fresh off reporting the industry's best August on record. Complemented by the draw of its iconic name, Winnebago Industries (page 5) is optimizing its product portfolio and consolidating manufacturing in a drive toward higher profitability. Its 2016 acquisition of Grand Design increases Winnebago's exposure to the fast-growing market for towable RVs.

Speaking of icons, Nomad Foods (page 4) brought back Captain Birdseye in an effort to reinject some identity into its frozen food offerings after pursuing a master-brand approach in its European markets. Still a highly recognized character in the United Kingdom, Captain Birdseye is symbolic of the company's decision to employ a customized approach that models marketing, packaging and product offerings to better reflect each of the 17 European countries it serves in order to drive sales.

The stock market can be fickle and it's susceptible to shocks, but it's not oblivious to the factors that most influence investor fortunes. Investors saw reason for continued optimism in the September quarter, pushing the bull market's tenure past eight-and-a-half years. We believe steady earnings progress is a primary reason.

Still, the current bull market's status as the second longest in history makes it unusual by definition. We recognize and respect potential risks moving forward. The market's ongoing march higher leaves valuations toward the higher end of our comfort zone, and we're stressing our reasonable price-to-earnings ratio discipline in portfolio management.

Paying the right price up front is an important part of the equation. Selling right plays an equally important role in managing risk and ensuring that the portfolios we manage represent collections of our best ideas. Please see page 6 for more on our sell discipline. Another article, on page 3, explores the changing retail landscape.

Moving into the final quarter of the year, we continue to isolate the most earnings strength in the technology sector. The consumer discretionary and health care sectors represent the next largest portfolio positions.

We're grateful for the opportunity to serve you. Thanks for your continued confidence.

Scott

Scott Gates
Chief Investment Officer

Navigating Retail Amid Digital Disruption

Gap recently announced it would be closing about 200 stores over the next three years. The apparel maker isn't alone. Toys "R" Us, Macy's, Michael Kors Holdings, The Limited, Gymboree Corp., Guess, J.C. Penney Co., H.H. Gregg, RadioShack, Sears Holdings Corp. and a long list of other brick-and-mortar retailers are shuttering storefronts as shoppers continue to shift their dollars online.

Credit Suisse believes that there could be 8,640 store closings this year, which would surpass the 2008 peak of 6,200. Meanwhile, Amazon uses its $99-a-year Prime Membership as a way to gain customer loyalty and simplify the shopping experience. The company is expanding new services like same-day delivery service Amazon Now in a growing number of markets. It's also making partnerships with brands like Sears and Kohl's, and now counts hundreds of Whole Foods Markets stores among its assets.

Traditional retailers that are invested heavily in stores and distribution now face the added costs of competing with an online giant. Ramping up online sales while maintaining store fronts and price points creates considerable profit margin pressure, leaving tough choices and, in many cases, unhappy shareholders.

Macy's market value fell by roughly two-thirds over the past two years. J.C. Penney Co.'s stock price is down a little more than that since March 2016. RadioShack, which once operated 7,000 stores, plans to emerge from bankruptcy with just 400 independently owned locations.

Department store closings open the door for off-price retailers to better implement their bargain-based strategies. As department stores close, companies such as TJX Cos. benefit as close-out merchandise becomes available. The company plans to open more stores, including an entirely new concept called Homesense.

Ollie's Bargain Outlet also sells brand-name closeouts and excess inventory, so shoppers don't always know what to expect from one visit to the next in terms of merchandise. Calling it "treasure-hunt shopping," management views the changing product assortment as part of Ollie's charm.

More important, Ollie's is consistent when it comes to its promise to deliver "good stuff cheap." It operates roughly 50 more stores than it did at the time of its initial public offering in July 2015. The company also exceeded earnings estimates in every quarter since its IPO.

Growth at Dollar Tree also appears defensible from the so-called "Amazon effect." A $1 price point is something that is logistically uneconomical for online firms to compete against. Revenue is expected to grow 34 percent in the fiscal year that ends in January, helping create a 23 percent jump in earnings.

Ramping up online sales while maintaining store fronts and price points creates considerable profit margin pressure, leaving tough choices and, in many cases, unhappy shareholders.

Companies that sell products that demand an in-store experience also enjoy a degree of insulation from online competition. For example, purchasing in the cosmetic category remains a bastion of brick-and-mortar retail. Beauty buying is experiential and, based on sales trends, Ulta Beauty is an attractive place to go to try and buy. The company is the largest beauty products retailer in the U.S. The stores also dedicate space to on-site salon services, something Amazon can't replicate.

Consumers continue to shift more dollars toward services and lifestyle changes. Netflix is at the center of the changes taking place in how consumers view television and video. Last year, sales climbed 30 percent to $8.8 billion and are forecast to increase more than 27 percent this year. Driving revenue growth is the company's aggressive push into delivering original content to users.

Winnebago Industries benefits as a younger demographic increasingly seeks to travel more often and enjoy active outdoor lifestyles. The RV industry is enjoying a strong sales cycle, and new management at Winnebago is looking to capitalize on it with new products and a focus on profitability.

Consumer discretionary stocks are currently among the most heavily shorted in the market, where investors try to benefit from declining share prices. Still, consumer discretionary companies comprise our second largest position firm-wide. Reports of brick-and-mortar retail's demise are premature, as the earnings strength that we've identified in the sector demonstrates. If approached selectively with a focus on fundamentals, we believe there's still a lot to like in the sector.

Albemarle Corp., ALB

China just announced a commitment to wind down production and sales of cars using fossil fuels. As governments, manufacturers and consumers shift toward electric vehicles, demand for the chemicals that power them grows. Albemarle is the largest global producer of lithium, which is used to make the lithium-ion batteries.

NYSE-listed Albemarle Corp. is a specialty chemical producer with leading positions in lithium, bromine and refining catalysts. Responsible for more than one-third of worldwide output, the company is the biggest vertically integrated presence in the lithium market. Strategic mining assets and expansion projects in Australia, Chile and China allow the company to meet demand. Sales reached $2.8 billion in the 12 months through June.

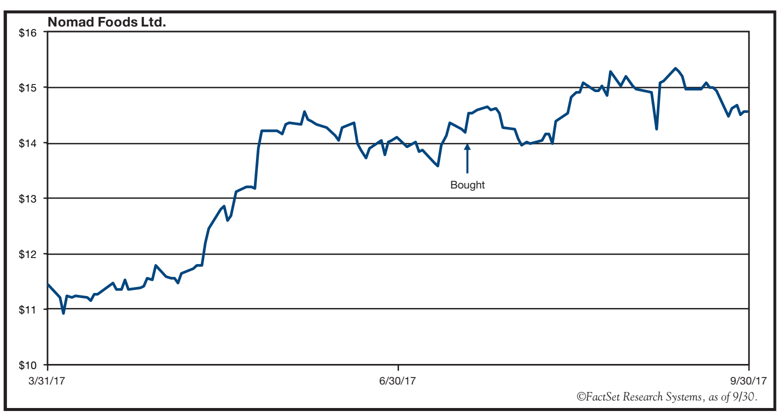
June-quarter earnings grew 21 percent, exceeding the consensus estimate. Revenue rose 10 percent, as lithium-related business offset weakness in bromine and refining. Lithium sales grew 55 percent versus the year-ago period, with pricing up 31 percent.

The expansion of the electric vehicle market is a key factor in rising Lithium demand. Tesla's new Gigafactory in Nevada alone is expected to produce enough lithium-ion batteries to power 500,000 electric cars per year by 2020.

Your team spoke to Chief Financial Officer Scott Tozier about how the company's ability to increase capacity is an advantage over new competitive entrants, which face considerable start-up costs and technical challenges. Albemarle announced a new technology that will allow it to obtain more lithium out of its existing brine assets in Chile's Atacama salt flat.

We expect the added lithium capacity Albemarle plans to bring on-line this year and next to help support profit margins and earnings growth. Based on the consensus estimate, Wall Street expects Albemarle to finish 2017 with 22 percent earnings growth.

Nomad Foods Ltd., NOMD



The Captain is back. Maybe that doesn't mean anything to you, but Nomad Foods is betting that his reemergence is appealing to British children and, by virtue, the parents who decide what frozen foods to buy on their behalf. Captain Birdseye is a key figure in an overseas campaign to sell more fish sticks, potato waffles and peas.

Nasdaq-listed Nomad Foods Ltd. sells frozen foods under the brand names Birds Eye, Iglo and Findus. With sales in 17 countries, the company focuses on markets in Western Europe, generating the majority of its revenue in the United Kingdom, Italy, Germany and Sweden. Sales topped $2.1 billion in the 12 months through June.

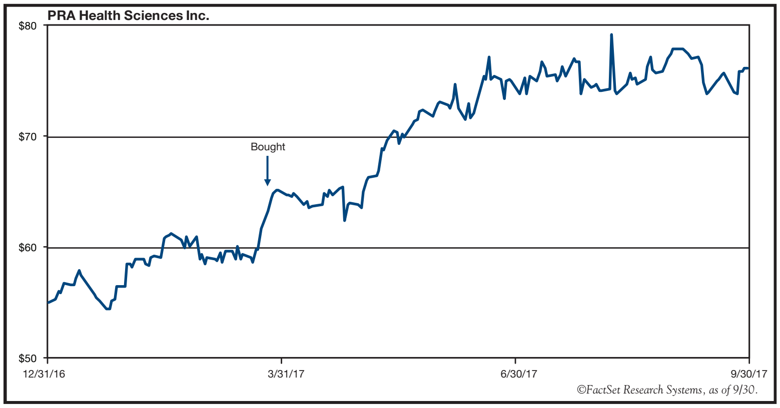
Nomad in September launched a series of promotions to celebrate the 50th anniversary of Captain Birdseye, an until-recently abandoned marketing character that remains highly recognized among consumers. Captain Birdseye's return is part of a bigger transformation away from Nomad's previous master brand approach to a more product-focused strategy, including quality and packaging upgrades on roughly five dozen products.

Marketing strategy, product improvement and expense discipline appear to be paying off. Nomad grew June-quarter earnings 35 percent, exceeding the consensus estimate by 19 percent. In addition to generating organic revenue growth and expanding profit margin, the company repurchased 5 percent of its outstanding shares during the quarter.

Your team spoke with Chief Financial Officer Paul Kenyon about Nomad's "must-win" approach to making its products share leaders in different markets. In addition to broad-appeal offerings like fish sticks, the company designs products to cater to the diverse local tastes in its various markets.

Based on the consensus estimate, Wall Street predicts Nomad will finish 2017 with 23 percent earnings growth.

PRA Health Sciences Inc., PRAH



Choices abound for drug makers in search of a dedicated research partner they can hire on a contract basis to perform some of the work necessary to bring their products through development and into the marketplace. Still, PRA Health Sciences continues to grow faster than the overall contract research business, showing that the company is a popular choice.

Nasdaq-listed PRA Health Sciences Inc. is a contract research organization, or CRO. It provides outsourced clinical development services to customers in the fields of biotechnology and pharmaceuticals. Developers employ its services, including data management, statistical analysis, clinical trial management and development consulting, for everything from niche treatments to blockbuster drugs. Revenue increased 15 percent to $1.7 billion in the 12 months through June.

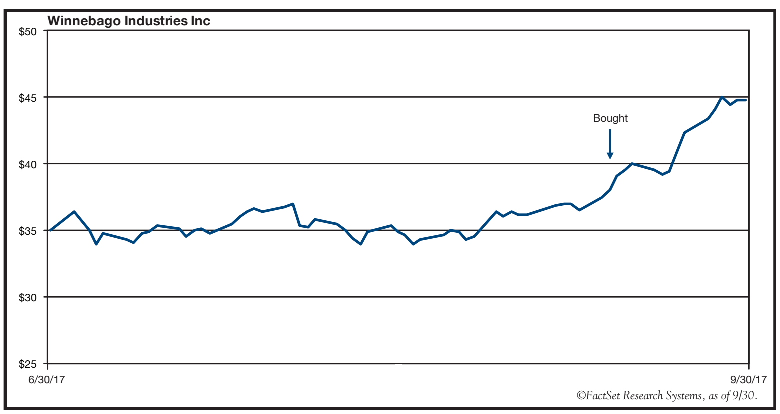
PRA boasts a data trove that includes more than 280 million patients and 10 billion pharmacy claims, representing vast and valuable resources that can be used to quickly recruit patients for clinical trials. The company also offers predictive analytic solutions used to design trials and, as in-trial data become available, modify protocols as needed.

PRA grew June-quarter earnings 25 percent, exceeding the consensus estimate, as revenue climbed 17 percent. The company generated $603 million in net new business during the period.

Your team spoke with Chief Executive Colin Shannon about PRA's recently announced agreement to acquire Symphony Health Solutions Corp. The deal allows PRA to leverage Symphony's cloud-based data and analytics assets across its global geographic footprint.

Your team bought PRA shares at 18 times earnings estimates for the 12 months through June 2018. Based on the consensus estimate, Wall Street predicts the company will grow earnings 29 percent over that span.

Winnebago Industries Inc., WGO



Late last year, Winnebago announced it would purchase Grand Design, a move that would increase Winnebago's exposure to the fast-growing market for towable recreational vehicles (RVs) in a big way. In this and other ways, a new management team aims to take Winnebago on the open road to future growth.

NYSE-listed Winnebago Industries Inc. is a leading RV manufacturer, an iconic brand in leisure travel and outdoor recreation. The company builds motorhomes, travel trailers, fifth wheel products and toy haulers under the Winnebago and Grand Design names. It markets its RVs on a wholesale basis to dealers throughout the U.S. and Canada. Sales grew 41 percent to $1.3 billion in the 12 months through May.

At a recent conference, Chief Executive Michael Happe addressed Winnebago's path toward renewed competitiveness and profitability beyond increasing the percentage of revenue generated by towable RVs. The company reduced a portfolio consisting of 32 brands of motorized homes to 16, while maintaining a broad range of pricing. Winnebago is also actively consolidating manufacturing and improving efficiency.

May-quarter earnings grew 57 percent as revenues jumped 75 percent (including the addition of Grand Design). Gross profit margins improved as towable RVs accounted for more than 40 percent of revenue. While motorized home sales declined slightly due to pricing adjustments, the company showed progress toward product-line rationalization efforts.

August data from the RV Industry Association showed total RV shipments were up 25 percent in the month, marking the best August on record. In September, Winnebago announced three new motorhome offerings, including a new low-priced Class A coach motorhome and its first ever 4x4 RV. Consensus expectations predict Winnebago will finish fiscal 2017 with 34 percent growth.

When Our Investment Strategy Says Sell

Dick's Sporting Goods was delivering the kind of results we like to see. In March, the company reported its fourth consecutive quarter of earnings growth that exceeded consensus expectations. Sports Authority was only days removed from seeking bankruptcy protection, and the collective assumption was the competitor's troubles were likely to benefit Dick's.

The Friess investment strategy prompts us to constantly challenge the assumptions made to justify each company's appeal as an investment. The reason we conduct continuous research on existing and potential holdings is to ensure the portfolios we manage represent collections of our best ideas. Our sell discipline plays a central role in that effort.

We didn't uncover evidence of a material uptick in store traffic at Dick's in the weeks that followed Sports Authority's filing. Later, when the bankruptcy went from a reorganization to a liquidation, our trade checks identified deeply discounted Sports Authority inventory as a near-term threat to Dick's sales.

We also spoke to industry experts who bemoaned a lack of innovation in key sporting goods product lines. Without the draw of must-have items from Nike or Under Armour in the run-up to back-to-school season, we tempered our in-house earnings forecast. Based on our research, we grew concerned that the consensus view for coming quarters didn't fully account for the headwinds Dick's faced.

It was time, in early May, to sell. Given that we want to own companies that top expectations, we move on when we believe consensus estimates overstate a holding's potential. A week later Dick's reported results for its fiscal first quarter that met the consensus earnings estimate with sales that fell just shy of expectations. Fiscal second quarter results undershot both earnings and revenue forecasts.

Dick's is a well-run company, and we wouldn't hesitate to own it again under the right circumstances. With that said, our sell discipline directs us to recognize the time value of the assets entrusted to our care. Each day we must ask ourselves whether we're putting the assets we manage to their most productive use, based on the individual-company assessments we develop through bottom-up research.

Our goal when we make a change within a portfolio is to replace a good idea with a great one. Sometimes the process is initiated by a concern, as in the case of Dick's. Other times, however, there's an as-yet unowned newcomer that we're eager to find a spot for because its outlook appears more promising than a company or companies that we already hold.

We call the process "forced displacement." To keep the portfolios we manage stocked with our best ideas, we challenge our original assumptions about a holding and compare it to available alternatives. That means existing holdings must continuously earn their keep by showing more upside potential than a new buy we're considering based on their respective fundamental outlooks.

Forced displacement triggers a sale when assets from an existing holding are needed to fund the purchase of a new, more promising investment opportunity. We also sell an existing holding when it reaches our price target or its fundamentals deteriorate.

Since we're valuation-sensitive, our price targets can be more conservative than aggressive growth investors that are willing to shoulder higher valuation risk. We seek companies with improving fundamentals, so we don't hesitate to sell a company when it proves that our initial assessment was wrong.

Our sell discipline is part of a broader strategy that stresses the power of individual companies to influence their share prices through operational performance. We capitalize on the relationship between earnings results and stock prices by isolating companies poised to deliver rapid earnings growth that enjoy good prospects to exceed Wall Street earnings estimates. To maximize upside potential and minimize downside risk, we focus on rapidly growing companies that sell at reasonable multiples of earnings estimates.

Exhaustive, company-by-company research is the key to our approach. Friess researchers spend their time on the economy's frontlines, conducting interviews with company managements, competitors, customers and suppliers to glean insights on existing and potential holdings.

In the end, the portfolios we manage represent collections of our best ideas at a given point in time. Change is a persistent theme as the backdrop evolves and companies enjoy various degrees of success in executing their plans. When our sell discipline prompts us to sell a company, there's nothing to prevent us from revisiting the same company at some point in the future should conditions warrant a fresh look.

On the Cutting Edge

Examples of innovative and interesting ideas that cross your team's radar screen make it into this column each quarter. The chance to capitalize on investment opportunities related to them may lie in the future or may never materialize.

Smart Sleeve Technology

As ubiquitous as wearable technology is becoming, meshing it with the fashion industry remains a challenging feat. Enter Levi and Google. The two icons collaborated on a project called "Jacquard," producing a smart denim jacket that can do everything from read you your texts aloud to seamlessly shuffle through your music with a simple brush of the sleeve. Created by Levi designers and a small division at Google dedicated to experimentation, the Levi Commuter Trucker jacket is equipped with a small removable Bluetooth dongle that pairs with interactive fabric woven into the left sleeve. Users can control music, navigation, messaging and phone functions by applying hand gestures to the sleeve's surface. The conductive yarn can be paired with an app that allows for easy switching among functions. Also, the jacket can be washed without compromising the technology's integrity. Current retail is $350.

Generosity Meets Need on Social Media

Facebook launched an application aimed at helping blood donors connect with recipients. The social networking platform is rolling out a new feature designed for its second-largest user base, India. Starting October 1st, India's National Blood Donor Day, Indian Facebook get the opportunity to save a "friend's" life. The country suffers from a blood shortage. Blood banks in the country are stocked 10 percent below current needs, creating a situation where many patients are responsible for replenishing supplies themselves, often asking family and friends for donations. With millions of users in India, Facebook hopes to help make a difference. Users can register and match themselves with individual patients, hospitals and blood banks in need, making it easier to connect blood donors with those seeking donations.

Robo-Touch

Researchers at the University of Houston created a "skin" that they say allows robots to sense touch. The artificial skin-like material combines a silicon-based polymer called polydimethylsiloxane and nanowires 1,000-times thinner than human hair. Different than other semiconductor materials, the skin can be easily stretched and applied to surfaces such as a robotic hand. With the skin applied, a robotic limb is able to feel hot and cold temperatures. In testing, a robotic limb outfitted with the skin also translated computer signals into American Sign Language. In the future, the team believes polydimethylsiloxane skin could be used for a variety of medical implants, surgical gloves and stretchable electronics.

Calling All Mosquitos: Buzz Off

In the past, electronics company LG applied ultrasonic wave technology to air conditioners and televisions to help repel mosquitoes. Now, the company is equipping its new LG K7i smartphone with the inaudible ultrasonic wave feature. Recently launched, the phone is currently only available in India, a country that suffers greatly from diseases like malaria and dengue that are spread though mosquito activity. Featuring a 20 kHz ultrasonic frequency, the K7i mobile phone showed a 72 percent success rate of repelling mosquitoes during a clinical trial. The technology works to keep disease-carrying mosquitos in check without any of the side effects present in traditional chemical repellents.

Stop Bothering Your Brother

People's ears tend to perk up when they hear: "This is your captain speaking." Imagine enjoying that same attention-grabbing power while speaking to the passengers in the backseat of a minivan. Showcasing its new Cabin Talk system in its 2018 Odyssey minivan, Honda incorporated a rear-facing, multi-view camera and PA system that allows the driver (or captain) to monitor passengers in the second and third rows. The system features a wide-angle lens with infrared lights mounted to the ceiling that allows the front-seat passenger and driver to easily keep an eye on what's happening in the back seat day or night. The Odyssey's Cabin Talk system also allows the driver to verbally direct back-seat behavior through the van's speakers.

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As of September 30, 2017, Albemarle Corp., Amazon.com Inc., Dollar Tree Inc., Netflix Inc., Nomad Foods Ltd., Ollie's Bargain Outlet Holdings Inc., The TJX Cos. Inc., Ulta Beauty Inc. and Winnebago Industries Inc. represented 2.10, 1.89, 1.83, 1.89, 1.01, 1.36, 1.54, 1.22 and 1.04 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Albemarle, Amazon, Dollar Tree, Netflix, TJX and Ulta Beauty at 2.42, 2.92, 3.42, 2.83, 2.04 and 1.49 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held Albemarle, Dollar Tree, Nomad, Ollie's, PRA Health Sciences Inc. and Ulta at 2.36, 3.36, 1.72, 1.74, 2.13 and 1.39 percent of assets. Other securities discussed were not held by the Funds. Earnings per share, or EPS, is the portion of a company's profit allocated to each outstanding share of common stock. The Price-to-Earnings (P/E) Ratio is calculated by dividing current price of the stock by the company's estimated earnings per share for the current calendar year. "Bought" date highlighted in stock charts represents the initial purchase date by Friess Associates. The S&P 500® Index is a capitalization-weighted index. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The index is unmanaged, unavailable for investment and does not incur expenses. Friess Associates LLC serves as the subadvisor to certain mutual funds advised by AMG Funds.

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