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Speaker Details:

S1 – Tracy Rogers, *Moderator*
S2 – Joe Fields, *Managing Partner for Friess Associates*
S3 – Scott Gates, *Portfolio Manager for Friess Associates*

Transcription:

S1 00:00 Good afternoon and welcome to the Friess Associates Q3 2017 webinar. After today's slide presentation, we will take some time to review topical questions that have come up in recent conversations with our prospects and clients. I would now like to turn the conference call over to Portfolio Manager, Mr. Scott Gates; and Managing Partner, Mr. Joe Fields of Friess Associates. Gentlemen, please go ahead.

S2 00:22 Thank you Tracy. My name is Joe Fields; I'm a Managing Partner at Friess Associates. With me is Scott Gates, our CIO and Portfolio Manager on our small cap fund. Scott and I would like to update you on our third quarter performance and attribution, along with sharing some background on our firm, investment process, and longer-term results. Background on page two on Friess Associates. We were founded in 1974 and are an employee-owned firm. Our intensive all-cap research is the cornerstone of our investment discipline. Our small cap strategy, which began in 1981 and has a 35-year history. This strategy had only been available to institutions and ultra-high-net-worth investors until we launched our mutual fund in June of this year. We're thrilled with the initial interest in our fund and to be partnering with Dakota Group in growing the assets for our clients in the years ahead.

S2 01:29 Page three highlights our investment strategy. We believe earnings drive stock prices. Our founder, Foster Friess, was fond of saying, "Three things drive a stock's price: earnings, earnings, and earnings." Friess Associates employs deep-fundamental, all-cap research to identify companies that are experiencing accelerating earnings growth. Our goal is to invest in companies where the earnings delta between the Street's estimates and our own Friess earnings estimates is very wide. Once the Street recognizes this earnings potential and the stock is fully valued, we sell. An experienced group of research analysts conduct our fundamental research and are highlighted on page four. Our team averages over 15 years at Friess and over 21 years in the industry. Let me turn it over to Scott to do a deeper review of our investment process.

S3 02:36 Thanks Joe. On page five, and this gives you a sense on how we begin to isolate candidates that go into our portfolio. So this is our pool of candidates starting with the 3,000 companies out there. Simply looking for earnings growth of 20% or higher, a reasonable P/E that we can attach to that earnings growth, and we'll look at peer historical as well as market multiples to arrive at the proper P/E; experienced management that have a history of execution, a strong balance sheet. Finally and most importantly, we are looking for an earnings catalyst that will likely exceed consensus earnings estimate out there. What I mean by a catalyst is an earnings call where they've beat and raise, possibly a new product, a new market, or maybe a change in the competitive landscape. What we are trying to do is find something that will ignite the Street's interest in this particular name.

S3 03:36 So as we move down onto page six, this gives a sense on our differentiation. As Joe said, deep intensive research. This slide would be very similar to one that we would have had 25 years ago in a slide deck. As Joe said, it's an all-cap approach. We're talking to large cap, mid cap, small cap companies developing those conversations and meetings with customers, competitors, and suppliers, private company, consultants, all around our target company, really trying to build a mosaic of data to help make best decisions. It is real-time research, with a lot of sharing amongst the research group, a lot of cross-pollination with all of this data that they're gathering. It's transcripted real-time into our digital research base, over a hundred contacts a week are added to our 25,000 industry contacts within our database now. So there's a real emphasis on teamwork and leveraging resources, contacts, and expertise across our research group.

S3 04:48 Just as important, it is that we have conviction on our buys, and I'm on page seven now, it's very important that we have discipline on our sales. There are four reasons we'd sell a name. Number one, our price target is achieved. We reach our price targets on our earnings upside, not on assumption that the multiple could expand. So we can control and do our work on what that earnings estimate could be to generate a price target. Secondly, Wall Street may become overly optimistic on the story that we've uncovered. Either they're above management's guidance or they're above our guidance, thus setting up a situation where they possibly could miss earnings. Thirdly, fundamentals deteriorate. Through this process, there's a lot of maintenance research that continues with a name and we may find data points that change the thesis on why we bought this name from the beginning. That too may force the sell.

S3 05:55 And finally, forced displacement. We rank all of our stocks daily as to the upside to their price target. When we find a name that has 45% upside and we own a name that only has 2% upside (and we simply can't get any more upside), from our process standpoint, that company is "fully priced". We will forcibly displace that stock and replace it with this new 45% upside name. This leads to the strongest ideas in our portfolio and optimizes time value of money for our clients.

S2 06:33 Our portfolios are designed with risk controls in mind. On page eight, you could see these risk controls highlighted. The key risk control is our deep fundamental research, knowing our companies better than the street and our competitors. We're also vary valuation sensitive as Scott mentioned. We're not willing to pay up for outsize earnings growth. We also limit our sector exposure to 35% in the larger growth sectors, 15% for the smaller sectors in the index. We also limit our industry exposure to 15%. And key to our small cap portfolios is liquidity risk. A full position at initial purchase is 2%, which allows the company to grow but not become an outsized portion of the portfolio. As we say, we don't want to own a private placement in our portfolio.

S2 07:43 Let's turn to the performance record on page nine. And for the September quarter, our fund out-paced, the Russell 2000 by 8 basis points and underperformed, the Russell 2000 Growth by 47 basis points. On a longer-term basis, over three and five-year period, we have outperformed the indices by over 500 basis points on an annual basis. With regard to attribution of our performance for the third quarter, and highlighted on page 10, are the sector weightings. Our portfolio is overweight, technology, financials, and consumer staples, while underweight, healthcare and industrials. The consumer discretionary and financial sectors outperformed during the third quarter, while the technology and healthcare sectors underperformed. Scott will highlight a few individual stocks that drove this performance.

S3 08:40 Well, let's look at two names. They both are in the tech space. One was certainly a contributor and one was a detractor in the quarter. Let's start with the detractor, EMCORE Corporation. They develop compound semiconductors for the cable and defense business. A lot of conversations we've had with the large cable companies, which are their customers and suppliers, like ARRIS, are about what the next generation's cable standards are, called DOCSIS 3.1. These conversations are very positive, but the timing of the rollouts was delayed. So we expect this to return in the fourth quarter and still like the name very much. Another driver specifically for this name is through various conversations with one of their partners, Mercury Systems, which we own in the small cap as well. We believe they have won a multi-year fiber-optic gyroscope for the use in drones and missiles. So, that too we think hits in the fourth quarter.

S3 09:50 On the contributor's side, Axcelis was a terrific contributor for us in the quarter. They make semiconductor equipment. Their ion implantation products are vital to the production of semis, specifically focused in the memory business. So we were hearing some very positive things about the company, specifically about their new Purion products line. In the production of memory chips, customer comments from Micron, which we own in the large cap, Himax, and TSM, and others were very positive. Supplier comments from a private company called Rodel that makes a lot of the slurries a little bit before in the production line of semis gave us very good commentary as well as the traction with Purion. As well as their competitors Applied Materials and Lam Research were continuing to lose share to this particular product line. Sure enough, the company pre-announced upsize in the quarter on margins, on orders, and earnings per share. So I think both of these give you a good sense on this all-cap approach and us talking to the customers, competitors, and suppliers that span the market caps.

S2 11:18 Thanks Scott. Highlighted on slide 12 is our up/down capture chart for our small cap strategy. Over the last five years, we've captured 112% of the upmarket returns, and only 45% of the down market returns. Slide 13 is our peer analysis chart, which demonstrates our competitive results versus our peer group. And slide 14 highlights our top 10 holdings, which represent 23% of our small cap portfolio. These 10 holdings represent a range of sectors including technology, financials, healthcare, consumer discretionary, and energy.

S2 12:06 Final slide for our presentation is what we call our proof page. Are we finding companies that are growing their earnings faster than the Street anticipates? As you can see from the slide, our portfolio is generating four times the earnings growth rate of the Russell 2000 index and one and a half times the growth rate of the Russell 2000 growth index. Our multiple is in line with the benchmarks. We currently hold 52 stocks in our small cap portfolio with a median market capital of $1.7 billion and a weighted average market cap of $2.2 billion. This concludes our prepared remarks. We would like to share with you a few questions that we've been asked during our travels. First one, Scott points to our underweight in healthcare, which is a large portion of the index. Are we not finding opportunities in the healthcare sector?

S3 13:16 Well our visibility into future revenues, cost, reimbursement has really made healthcare a difficult sector for us to find ideas. It is topic du jour with ObamaCare or TrumpCare. And so compounding an almost daily barrage of news regarding changes makes it difficult for us to find, as well as management to give us visibility on what their earnings stream can be. Also, our process requires positive free cash flow in earnings, so many of these biotechs, which make up a big percentage of our benchmark, have very binary characteristics that really don't fit our process.

S2 13:58 Great, thank you. Second question that comes up in our travels is regarding tax reform and how it should benefit small cap companies.

S3 14:12 Clearly, the biggest beneficiaries of tax reform, i.e. lower corporate tax levels, will be smaller cap companies. On average, our companies, as well as those in the small cap universe, pay a higher level of tax, income tax, than their large and mid cap competitors. But this really doesn't change our thesis on why we own our names. We own our names for very secular stock-specific reasons: significant upside to earnings, new products, new markets. So tax reform really would be an additional upside to our earnings estimate. Be icing on the cake, if you will. So it's a very favorable backdrop if corporate tax and tax reform does happen, but it's not necessary for our companies to reach their price targets.

S2 15:05 Thanks. With that, this concludes the webinar. We would like to thank you for your interest and time. If there are any questions, please contact us at Friess Associates. Thank you.

S1 15:20 Thank you very much Scott and Joe for taking the time today. The webinar has now concluded and thank you for listening.