Looking Forward

Friess Associates market observations and insights

Dec 31, 2017

Rebalance, Rotate – Rely on Earnings

Right now a lot of folks are participating in an annual ritual. Fresh from a year that likely knocked many thoughtfully constructed models off kilter, they're sitting down with their trusted financial advisers to discuss "rebalancing," the process of adjusting portfolio positions to achieve a desired baseline allocation.

It involves taking a personal financial inventory in the present, drawing from market action in the recent past and developing expectations for the near future. Another year older, maybe it makes sense to increase exposure to income-producing investments in 2018. Or, despite proving your initial skepticism wrong, it still seems like a good time to redeploy elsewhere the proceeds from that brief and exciting bet on Ukrainian stocks.

While the possibilities vary by individual, that's not the approach we take in managing portfolios on behalf of clients and shareholders. The role that we might play in an investor's aggregate collection of investments is constant. To us, it never makes sense to diversify away from earnings.

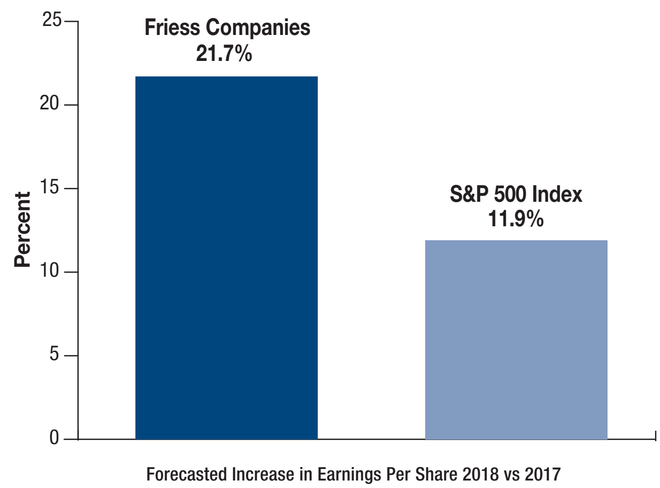
We're not recommending that you ditch other investments and go all-in with an earnings-driven strategy alone. To be clear, we are in no way attempting to provide any investment advice at all. Rather, rebalancing serves as a useful analogy because of the parallels it shares with market rotations, or changes in leadership that occur when investors sense that something might be off kilter relative to the baseline conditions that originally helped push the leaders to the forefront.

Technology stocks, which were dominant through most of 2017, saw their fortunes turn as the year came to a close. Sleepy financial stocks, on the other hand, perked up. Market watchers called it the start of a rotation, most likely sparked by the U.S. Federal Reserve (the Fed) commenting about being less accommodative regarding interest rates. The interpretation is that higher rates sap investor tolerance for the higher valuations present in the technology sector while also making it possible for banks to lend more profitably.

Another version of the rotation story emerged soon after as the Tax Cuts and Jobs Act came to be. The lower-tax technology sector was still on the outs, but the positive attention in this instance turned to higher-tax areas such as telecommunications, consumer staples and retail. Tax cuts for the latter three look to carry more heft.

Both rotation scenarios seem reasonable enough. After all, a lot of smart people work in the investment business, and part of what they do is extrapolate the likely ramifications of current events into potential future outcomes. Still, there's good reason to use words such as "likely" and "potential" when describing that exercise.

Estimated Earnings Growth



Source: Consensus estimates from FactSet Research Systems Inc., as of Dec 31, 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.

Even if it's educated, the market action behind the theories reflects knee-jerk analyses. Sure, higher rates could test valuations, but the Fed repeating yet again that it is gradually seeking to bring rates to a neutral level after years of stimulus is hardly a revelation. Likewise, we might agree that a more meaningful tax cut is preferable, but that becomes a moot point if the company enjoying the break can't grow earnings via operations.

Earnings demand prime consideration in any analysis that tries to determine whether market tides are shifting. Although we look at interest rates, tax cuts and other broad issues as legitimate reasons for stocks to move at various times and in different directions, we don't credit them with long-term predictive value when it comes to picking stocks. Stocks are ownership interests in for-profit companies, marrying their ultimate value to the operational fortunes of the companies they represent.

So, as other investors wrestle with market-moving topics as they emerge, we remain focused on individual-company earnings trends. Looking out into the year ahead, we like what we see. Based on consensus estimates, the average company held in Friess-managed portfolios is expected to grow earnings 21.7 percent in 2018. The average 2018 earnings growth rate for the S&P 500 Index is expected to be 11.9 percent.

The technology sector continues to offer the most abundant supply of earnings strength. Many trends in the sector, both new and long-running, are transformational. Far-reaching in nature, the ability to capitalize on them can lead to out-sized growth. ServiceNow (page 5) is a good example.

Cloud computing, which offers computing resources over the Internet, continues to drive exponential growth opportunities in many directions. Providing software as a service (SaaS), where customers pay to use software like a utility rather than buy it and store it on in-house systems, is one of the fastest growing cloud-based businesses. And, within that high-growth segment, ServiceNow is among the fastest growing companies.

ServiceNow is the fastest growing enterprise software company with more than $1 billion in annual sales. The company offers products that manage information technology operations, analyze performance, automate manual tasks, standardize processes and consolidate legacy systems, among other things. Revenue grew 37 percent to $1.8 billion in the 12 months through September.

Proofpoint (page 5) is another company making the most of its ability to connect to customers via cloud services. The company's already robust business, providing security across a full range of communications platforms, picked up even more in the wake of high-profile security breaches such as the Equifax incursion. Proofpoint's revenue jumped 39 percent in the year through September.

Given their subscription-based structure, ServiceNow and Proofpoint offer considerable earnings visibility. ServiceNow, for example, enjoys a 97.7 percent customer renewal rate. Visibility is a valued characteristic in our investment approach and an article on page 3 details conditions that make health care a rewarding sector in our search for it.

Deckers Brands (page 4) enjoys steady demand that's to the lasting success of its iconic UGG brand footwear line. UGG generated about three-quarters of the $1.8 billion in revenue Deckers made in the 12 months through September.

With UGG at its core, Deckers is executing a plan to maximize efficiency and capitalize on rapid growth in its other brands. The company targeted $150 million in cost savings and tightened its distribution channels to concentrate on its best performing retail partners. Sales of its Hoka running shoes increased tenfold over the past four years. September-quarter earnings grew 25 percent.

The videogame market continues to evolve to the benefit of game makers as gamers increasingly embrace digital downloads as a delivery system. We believe Electronic Arts (page 4), which counts more than 300 million registered users around the world, is well-positioned to capitalize on the situation.

Digital revenue as a percentage of total revenue rose to 63 percent in the 12 months through September. Analysts estimate digital downloads provide a 20 percentage point operating profit margin advantage over game cartridges. Electronic Arts exceeded the consensus estimate for the fifth consecutive quarter in the September quarter.

As we begin a new year, we want to share our enthusiasm for supporting people and organizations that commit themselves to performing good works. Friess Associates considered it a special honor to recently participate in Delaware Hospice's 30th annual Festival of Trees as a sponsor. We thank everyone involved at Delaware Hospice for their dedication to fostering dignity, peace and comfort among patients and their families.

Thank you for your continued confidence. We wish you a very happy and healthy 2018. We're grateful for the opportunity to serve you.

Scott

Scott Gates
Chief Investment Officer

Health Care Offers a Dose of Visibility

When it comes to stocks, uncertainty is certain. Certain times feel more uncertain than others, but no one can ever claim to know what will happen from one day to the next.

We try to inject as much predictability into what we do as we can by consistently focusing on earnings. We believe earnings determine stock prices. Still, that connection is only important if we can get the earnings part right, which is why we try to isolate companies with earnings growth prospects that provide some degree of visibility.

Every sector and each company in it come with their own mix of shifting challenges related to visibility. Despite pronounced regulatory uncertainty in recent years, we believe the health care sector provides a favorable mix of visible growth potential. As we all know, demand for health care is persistent.

The secular trends behind the push for health reform – an aging population with greater health demands, skyrocketing costs and limited government resources – will remain in place regardless of how the system adapts going forward. In particular, confidence should continue to increase in companies with unique cost advantages, innovative quality-of-care improvements and new treatment options.

With almost 20 million members on its platform across 10,000-plus clients and more than one million annual visits, Teladoc is the market leader in providing fast and inexpensive physician interactions via telehealth. Given its market share lead in this category and the recurring nature of its revenue, the company starts any given year with the majority of its revenue already locked up. The disruptive nature of the company's technology gives us confidence that its double-digit organic growth rate is sustainable.

Tabula Rasa Healthcare is a medication risk mitigation software and pharmacy service provider to health care organizations. In addition to its own recurring revenue stream and high customer retention rates, we believe the company is positioned for success because it addresses critical yet highly unmet safety concerns. The company's unique ability to quickly identify drug interactions is becoming more important as the percentage of the population taking five or more medications increases and adverse drug events become more dangerous and expensive.

Vocera Communications also caters to a unique and growing need. The company's communications platform includes hands-free voice communication, secure text messaging and patient engagement tools that can be integrated into existing clinical systems. The Joint Commission, a nonprofit that accredits hospitals and health care organizations, estimates that 69 percent of accidental deaths and serious injuries in hospitals are caused by communication breakdowns, highlighting the critical function of communications systems. Visibility into the company's rapid growth prospects is aided by the fact that more than half of all hospitals are still using antiquated paging and wireless systems to communicate.

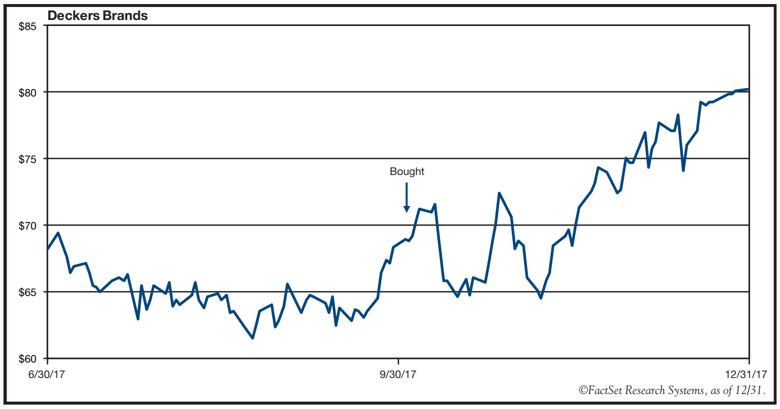
Biotechnology companies have accounted for an oversized portion of gains in the health-care sector. As the population ages globally, a push is being made toward a host of life-extending treatments. The Food and Drug Administration (FDA) is being more accommodative in its approval process while allowing for greater efficacy and expanding usage of existing medications. At the same time, improved knowledge about genetics is spurring new drug development for various diseases.

It's difficult for us to buy a start-up biotechnology company with its visibility tied to the binary outcome of one particular clinical trial. It's more likely we find diversified companies like Agilent Technologies and Thermo Fisher Scientific, which both provide tools and services across the fast-growing biotechnology space.

Animal health care is another place within the sector that offers a backdrop of high visibility because of strong demand trends for companion animal care and the unregulated nature of the business. Zoetis generates a diversified revenue stream across the livestock and the companion animal markets. New products, specifically aimed at the companion animal market, continue to perform well. The company's international expansion and investments in research and development will continue to make it less dependent on any one product or economy.

Every year brings opportunities and challenges, most of which are impossible to foresee ahead of time. Our experience tells us that companies that offer visibility because of their own internal fundamental strengths will recognize related opportunities and mitigate hazards best. We remain focused on uncovering innovative companies with what we believe are uncommon outlooks for earnings growth.

Deckers Brands, DECK



Fashion is a notoriously fickle business. Brands that misstep with customers risk stumbling out of favor. Guided by its iconic line of sheepskin boots, Deckers Brands manages to keep striding in the right direction.

Nasdaq-listed Deckers Brands designs and manufactures footwear. Its fashion lifestyle group consists of UGG, a premium brand responsible for more than three-fourths of revenue, and Koolaburra, a complementary brand available at lower price points. Hoka running shoes, Teva sports sandals and Sanuk surf-life-inspired kicks make up the company's performance lifestyle group. Sales topped $1.8 billion in the 12 months through September.

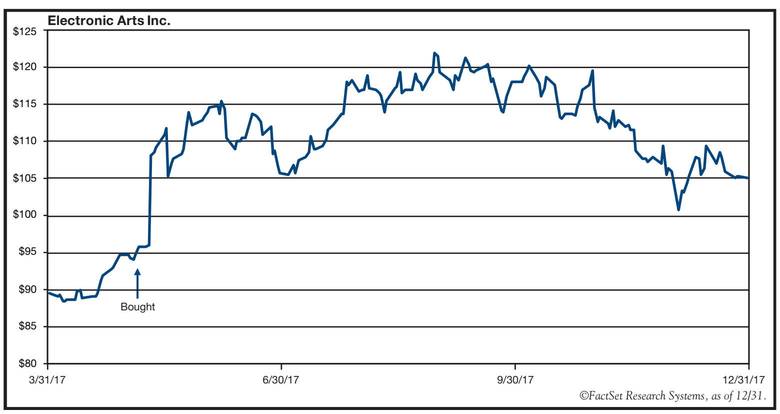
With UGG as its foundation, Deckers plans to build on it with a wider range of less seasonal footwear and products such as handbags and apparel bearing the UGG name. At the same time, the company aims to capitalize on its fast-growing Hoka brand, which grew revenue tenfold over the past four years, through strategic marketing efforts and new products.

Your team spoke with Chief Executive Dave Powers about the company's commitment to profitable growth. Initiatives adopted in 2016, including targeting $150 million in cost savings and realigning its distribution channels toward the best performing retail partners, are becoming evident in operating results.

Deckers grew September-quarter earnings 25 percent to $1.54 per share, exceeding the consensus estimate by $0.52 per share. The company subsequently raised its earnings guidance for its fiscal year ending in March.

Deckers also announced a new $335 million share repurchase program, which brought its total amount authorized for repurchase to $400 million, or 20 percent of outstanding shares at the time of the announcement. The company intends to buy back $100 million in shares by the end of March.

Electronic Arts Inc., EA



While industry analysts envision a day in the not-too-distant future when the gaming software business goes 100 percent digital, it's not there yet. There's still ample room to boost profits as downloading steadily supplants the game cartridge. Digital revenue continues to climb at Electronic Arts – and Electronic Arts continues to exceed expectations.

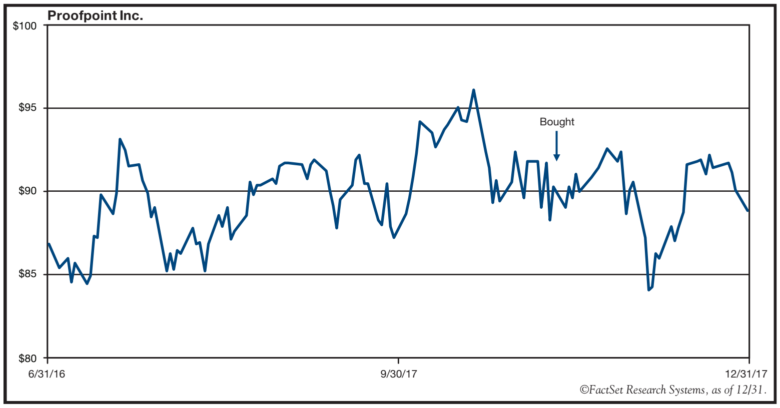
Nasdaq-listed Electronic Arts Inc. develops and delivers games, content and online services for Internet-connected game consoles, personal computers, mobile phones and tablets. The company counts more than 300 million registered players around the world and is recognized for its portfolio of popular brands, including The Sims, Madden NFL, EA Sports, FIFA and Battlefield. Revenue grew 14 percent in the 12 months through September to more than $5.1 billion.

Digitally downloading games eliminates the need for cartridges, which cost money to manufacture. A cartridge-free transaction means no packaging, no shipping and no retailer to get in the middle of the sale. Analysts estimate that downloaded games offer a 20 percentage point advantage in operating profit margins versus packaged games, on average.

Electronic Arts grew September-quarter earnings 25 percent, exceeding the consensus estimate by 21 percent. The results extended the company's string of positive quarterly earnings surprises to five in a row. Strength in mobile live services, The Sims 4 and Ultimate Team drove the upside.

Digital revenue as a percentage of total revenue climbed to 63 percent in the trailing 12 months, representing 26 percent year-over-year growth and marking the seventh consecutive quarter in which the company set a new high in that metric. In addition to conversions from cartridges, Electronic Arts benefits from a robust app-based business driven by in-game advertising, in-game purchases and premium mobile games for purchase.

Proofpoint Inc., PFPT



From the Equifax breach that compromised the personal information of almost half the country to global ransom campaigns like WannaCry that locked down more than 300,000 computer systems, successful cyberattacks are only becoming more frequent and costly. Proofpoint benefits as security remains a top-level concern for businesses.

Nasdaq-listed Proofpoint Inc. is a security as a service (SECaaS) provider protecting the sensitive data of mid- and large-sized companies against cybercrime. The company offers email, instant messaging, social media and other web-based solutions to defend against advanced persistent threats. Proofpoint also archives data for compliance and loss prevention. Sales grew 39 percent to $477 million in the 12 months through September.

September-quarter earnings topped the consensus estimate, rising 32 percent on 35 percent revenue growth. Increasing awareness amid recent high-profile breaches helped drive billings up 33 percent. The company also achieved significant growth in its protection and advanced threat product suite, which includes targeted-attack protection and emerging products, such as email fraud defense, threat response and social media protection.

Your team spoke to Chief Executive Gary Steele regarding how migration to cloud-based enterprise systems continues to drive demand for Proofpoint's services. The company continues to view the roll-out of Microsoft's Office 365 system as more of an advantage than a competitive threat, as the embedded protection functionality is proving insufficient for many customers. At the same time, recent acquisitions of Cloudmark and Weblife.io enhance the company's ability to protect users on cloud and mobile platforms.

Based on the consensus estimate, Wall Street predicts Proofpoint will grow earnings 38 percent in 2018.

ServiceNow Inc., NOW

Software-as-a-service (SaaS) companies offer technology investors some of the highest revenue growth available. ServiceNow is no exception. In fact, it's the fastest growing enterprise software company with more than $1 billion in annual sales. What is exceptional is that the company's top-line growth is organic.

Nasdaq-listed ServiceNow Inc. is an enterprise information technology cloud company that automates and manages technology service relationships. Organizations deploy the company's service to create a single system of record for information technology and to automate manual tasks, standardize processes and consolidate legacy systems. Sales grew 37 percent to $1.8 billion in the 12 months through September.

September-quarter earnings grew 65 percent, exceeding the consensus estimate. Revenue rose 39 percent, driven by large new deals, including 22 greater than $1 million in annual contract value and the company's largest ever government contract. Total billings were also slightly better than forecasted, with subscription billings up 38 percent.

While many competitors rely heavily on acquiring customers through acquisitions, ServiceNow plans to grow revenue to $4 billion by targeting its sales efforts on the world's 2,000 largest companies and landing bigger contracts. The company is also expanding into new markets, including human resources, customer service management and security.

Your team spoke with Chief Financial Officer Mike Scarpelli about ServiceNow's work to incorporate artificial intelligence into its service platform. The company is introducing a new machine learning engine designed to predict outages, forecast outcomes, benchmark performance, and automate routing and workflow.

Based on the consensus estimate, Wall Street predicts ServiceNow will grow revenue 31 percent in 2018, fueling a 50 percent increase in earnings.

Building Best-Idea Portfolios

The idea is to assemble an exclusive group. To us, a portfolio should represent a collection of our strongest ideas at any given point in time. Considering how many stocks trade on U.S. exchanges, the companies we isolate for purchase comprise a relative handful.

Even though our goal is to isolate a small group of high-quality companies, we insist on conducting far-reaching research. Whether a company becomes a holding or not, the insights we gather in our evaluation process become part of an evolving research mosaic that helps guide our ongoing search for individual-company earnings strength.

Our research process starts by casting a wide net. The minimum earnings growth requirement – typically 20 percent year over year – creates a universe of potential investments. We cull that group further through disciplines regarding valuation, balance sheet strength and upcoming earnings catalysts, among other considerations.

We look for companies with high earnings quality, meaning the earnings a company reports accurately represent its operational performance. We also seek to identify companies with earnings catalysts, such as new market opportunities or revenue streams, likely to drive upside and attract positive investor attention.

Still, no matter how good a target company looks after passing a series of fundamental hurdles, we evaluate the logic behind making a purchase within the context of price. We generally focus on rapidly growing companies that also sell at reasonable multiples of earnings expectations, usually less than 30 times forward estimates.

While Friess researchers target a select group, they operate freely within that pool of potential investments. Friess researchers are generalists, giving them the freedom to suggest the best ideas they uncover regardless of industry. Our generalist approach gives us the flexibility to nimbly move to the next pockets of earnings strength as the environment evolves.

Friess researchers also analyze companies free from market-cap constraints. When we seek to isolate a large company, for example, we search for insights from sources all over the market-cap spectrum. Rather than taking a narrow snapshot of large-cap stocks, our research covers a large-cap company's mid-cap supplier and its small-cap vendor. In our view, spanning a company's complete "food chain" allows us to uncover trends that foreshadow trouble or point to opportunity before they become obvious to more narrowly focused investors.

In the end, the research legwork we conduct is the final screen a company must pass to win and maintain a place in the portfolio. We use the term "trade check" to describe the interviews we conduct with company executives, customers, competitors and suppliers. Trade checks take place in person in settings that include company visits, trade shows and user conferences, and via telephone.

Since exhaustive, bottom-up research is the key to our approach, the Friess research team completes hundreds of trade checks in its ongoing effort to glean insights on existing and potential holdings. Trade checks represent one of our most fruitful methods of idea generation, with research legwork often uncovering promising opportunities outside of the initial direction of our investigation.

Friess Associates is an active, bottom-up manager. We use our company-level research findings to build portfolios one company at a time without regard to the composition of any particular passive index. Maintaining an individual-company focus typically results in portfolios with low correlations to benchmarks. After all, our goal is to outperform the indexes, not mimic them.

To keep the portfolio stocked with our best ideas, we follow a forced displacement discipline that leads us to replace the weakest links in the portfolio with new opportunities that investors have yet to fully reward. 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. We aim to replace good ideas with great ones.

In addition to ensuring the portfolio consists of our most compelling ideas, forced displacement reflects our appreciation for the time value of the assets entrusted to us. Rather than hold a struggling company through a rough patch in the hope of eventual recovery, we redeploy into an investment that we believe has better potential to pay off in the near-term future. We want to hold what we believe to be the best possible companies on your behalf at all times.

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.

Steep Decline in Brushing Time

Two minutes can seem like a long time when you're brushing your teeth. If you agree, you might be interested to know that an Austrian startup claims its product allows users to brush effectively in just 10 seconds. Called Amabrush, its makers describe it as the world's first fully automatic toothbrush. Amabrush consists of an antimicrobial silicon mouthpiece lined with micro-channels to deliver toothpaste and arrays of inward-facing bristles for brushing. A motor unit, which attaches to the front of the mouthpiece magnetically, causes the bristles to vibrate. Amabrush is designed to clean teeth using the Bass method recommended by dentists worldwide. The secret to the product's speediness is in its all-at-once approach – every tooth is brushed at the same time. Amabrush's promotional materials boast that time saved could amount to 100 days over the course of a lifetime. Crowdfunding posts for Amabrush estimate product delivery in February.

Barnacles Be Gone

Once firmly hitched along for the ride, barnacles, mussels and other hull-hopping marine organisms can materially degrade a ship's hydrodynamic efficiency. Left unaddressed, they can eat through paint and, eventually, damage the hull in a process called biofouling. From commercial shipping to recreational boating, keeping hulls clean is a big, relentless business. Developed in the lab at Kiel University and brought to market by the German startup Phi-Stone, a new anti-biofouling paint promises smooth sailing without the usual scraping and repainting. Unlike existing anti-biofouling paints, Phi-Stone's paint doesn't use toxins to kill barnacles (polluting water in the process). Instead, the Phi-Stone paint consists of a polymer composite of engineered ceramic particles and polythiourethane. Once applied, the paint makes the hull too slippery for most hitchhikers to ride along. The few white-knuckled barnacles that do make their way back to port can reportedly be wiped away with a sponge.

Urchin Backs Stop Cracks in Their Tracks

You know what's tough? A sea urchin's spine. That's right, even though it's made from a brittle material called calcite, a sea urchin's spine is exceptionally durable. The sea urchin's spine is so tough that researchers at the University of Konstanz in Germany used it as the inspiration in their efforts to develop a better form of cement. The sea urchin's secret, the researchers say, is in the nano-structure, where crystalline blocks of calcite are surrounded by pockets of softer material called calcium carbonate. Cracks that form in the calcite hit calcium carbonate and fail to spread. The team's similarly nanostructured cement greatly improved the performance of calcium silicate hydrate, cement's binder. The team claims their cement could make concrete 40 to 100 times stronger.

Seeing Helps Healing

Wound care can be a tricky business, primarily because important influences on healing and infection are invisible to the naked eye. Toronto-based MolecuLight offers a product designed to bring bacteria in wounds to light. Called MolecuLight i:X Wound Intelligence Device, the handheld device allows clinicians to take violet-light photos that result in fluorescence images, exposing bacteria. The images enable clinicians to address any harmful pockets of bacteria that may be present, measure wound size accurately and track the healing process. According to the company, studies show the device leads to 54 percent more accurate swabbing, 89 percent cost reduction and nine times faster healing versus outcomes from standard care.

Glass Takes a Smarter Approach to the Sun

When it's already hot inside a car or home, solar heat transferred through glass windows turns up the temperature. When it's cold, sunlight is a welcome contributor to indoor climate comfort. Researchers at the University of Delaware are developing a new "smart glass" that is designed to let the sun's rays shine through when they're wanted and reflect them when they're not. The smart glass consists of a layer of clear glass atop a sheet of 3D-printed plastic, with a thin space between the two. The plastic is patterned to be retroreflective, like a bicycle reflector or the letters on a stop sign. The sheet loses its reflectivity and becomes transparent when a fluid called methyl salicylate is introduced into the gap between the glass and plastic. Although smart glass using applied voltage to switch from clear to opaque is commercially available, cost prevents widespread use. The researchers believe their glass can be made at one-tenth of the cost of current smart glass.

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Earnings growth rates quoted refer solely to the estimated earnings growth rates of the average investment holding of Friess Associates based on consensus estimates. 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. Diversification does not guarantee a profit or protect against a loss in declining markets.

As of December 31, 2017, Deckers Brands, Electronic Arts Inc., Proofpoint Inc., ServiceNow Inc., Tabula Rasa Healthcare Inc., Teladoc Inc., Thermo Fisher Scientific Inc. and Zoetis represented 1.67, 1.15, 1.46, 1.51, 0.75, 1.03, 0.97 and 1.82 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Agilent Technologies Inc., Electronic Arts, ServiceNow, Thermo Fisher Scientific and Zoetis at 1.97, 2.10, 2.56, 2.01 and 2.44 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held Agilent Technologies, Proofpoint, ServiceNow, Thermo Fisher Scientific and Zoetis at 1.94, 1.94, 2.27, 1.18 and 2.30 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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