Friess Small Cap Growth Q4 2017 Webinar Transcript
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Speaker Details:

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Transcription:

S1 00:00 Good afternoon, and welcome to the Friess Associates Q4 2017 Webinar. After today's 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 CIO and Managing Partner Mr. Scott Gates and Managing Partner Mr. Gordon Kaiser with Friess Associates. Gentlemen, please go ahead.

S2 00:23 Thank you. This is Gordon Kaiser and my role at Friess Associates is Client Service. I'm joined by Chief Investment Officer, Scott Gates. We are set to review our organization and process and spend most of our time covering calendar year and December quarter results. With that, let's jump to page four. Friess end of the year was $1.2 billion assets under management. The small-cap strategy grew from $43 million at the end of 2016 to $110 million year-end 2017. Friess Small-Cap Growth Fund ended the year at $97 million assets under management. Turning to pages eight and nine, Scott will give us a quick review of our profit. Scott.

S3 01:17 Our investable universe for small-cap is in the $200 million to $4 billion market cap range, and our process further dictates our candidate pool. But generally speaking, what we want to see are companies with a minimum 20% earning per share growth, a conservative P/E that we can attach to that earning stream, strong balance sheets, experienced managements, those with a history of executing. And finally what we're looking for is an earnings catalyst, something that will impact the earnings stream and surprise the street, for example, a new product, maybe a new market, a change in the competitive landscape, and clearly an earnings upside conference call.

S3 02:03 We flip to slide nine or page nine. So once we get to our pool of small-cap candidates, the research process really kicks into high gear. And it's an all-cap approach and this is very important. We're talking to customers, competitors, and suppliers all up and down the market cap spectrum. In other words, large-cap customers, mid-cap competitors, small-cap suppliers, the entire food chain, if you will. These are public companies, private companies, consultants, and we pull from our 25,000 industry contact database that we've developed for 20 years. We do about 100 of these a week, these phone calls, meetings, and company visits. So what we're really trying to do here is put this mosaic of data around our target company to help us make best decisions and best time positive catalysts for our companies. All of this is done in real-time as these conversations are dictated into our digital transcription system and are pushed to everybody in research. This too is very important as every analyst is a generalist, with deep knowledge and years of experience in several sectors. So information is shared and cross-pollinated in real-time. Quick example, I may have an analyst in Nashville talking to the hospital companies, another in DC talking to healthcare trade association, maybe another in New York at a healthcare conference. All of these conversations, after they're done, are dictated and shared real-time in our system. So teamwork here is very essential to the process. What we're really trying to do here, the goal here, is to leverage resources, contacts, and expertise across the entire research group.

S2 03:55 Executing the process Scott described on a consistent basis yields results shown on page 15. We finished the year strong with a December quarter return of 7.44%. That compares to the Russell 2000 Growth advance of 4.59%. Calendar year 2017, the small-cap strategy gained 31.41% versus 22.17% for the Russell 2000 Growth Index. December 2017 marked the 5th consecutive year of generating returns in excess of the Russell 2000 Growth. From a relative return perspective, the strategy outperformed the Russell 2000 Growth three out of four quarters in 2017. On an annual basis, back to its 1981 inception, the Friess small-cap composite has outperformed the Russell 2000 Growth Index with that same 75% frequency. On average, technology was the largest sector and was modestly overweight in 2017. Industrial and healthcare sectors were the next largest. For the full year, the greatest contributors came from technology, financials, industrials, and healthcare stocks. On page 16, we can see the top contributors and detractors for 2017. Scott, can you go over some of these names?

S3 05:36 Sure. Let's look at the top five contributor lists. And for balance there, I'll go over a tech name, a healthcare name, and a financial stock. Firstly, AAOI, Applied Optoelectronics. They make optical components and devices - this is transceivers, transmitters - and really has been a beneficiary of the market's move from 40-gig speeds to 100-gig speeds in the optical transport. About 150% earnings per share growth, really only selling at twelve times. And the catalyst has been, they have owned the 40-gig space and are building significant manufacturing capacity at 100 gig. We ended up selling this name as it reached our price target, but we were also uncovering, through our research process, that many new players were entering the 100-gig device optical component space. Thus, the threat of margin compression and market share loss seemed inevitable. Secondly, AxoGen, AXGN. They make surgical solutions specifically focused on the peripheral nerve damage, regeneration, and repair. 100% plus earnings per share growth, selling at 50 times, half that growth rate. And catalysts really have been continued traction in the hospital setting as it relates to their graft technology. We ended up selling this name as well. It reached our price target. And finally, Green Dot, GDOT, a Fintech company focused on prepaid debit cards and load rebalance services. About 50% earnings per share growth, selling at 25 times. And catalysts continued to be new products, new partners, and programs, as well as larger players like AmEx exiting the space. Their new TurboTax deal and their Apple Pay Cash partnerships, two of their more recent important deals, should continue to drive revenue as well as margin and earnings well above street estimates. We continue to hold this name as well.

S3 07:52 On the detractor side, Meet Group, MEET, an online social networking company. They didn't meet their internal timeline to introduce video into their offering. So it was delayed, and this has had a detrimental effect on their revenue and margins. We ended up selling this. And they subsequently had a weak guide. Another detractor is U.S. Silica, SLCA. They're in the production, the fracking sand business for petroleum drilling, primarily horizontal drilling, and they have key areas in the Permian Basin. 100% growth rate selling at 20 times. They continue to execute very well. It's a beat and raise story. But we continue to see significant new players with the threat of new capacity coming into that business. So it too was sold, although it continued to execute.

S2 08:51 Page 17 compares year-end 2017 sector weight with year-end 2016. Technology weight declined over the year yet remained overweight the benchmark. Industrial and consumer discretionary sector weight increased over the year and were overweight the benchmark at year-end. Turning to page 18, we'll highlight some of the contributors and detractors for the December quarter. Healthcare, financial, and technology sectors made positive contributions. Scott, would you care to highlight any of the contributors?

S3 09:31 Okay. Well, NMIH, a name we still own, NMI Holdings, it's a private mortgage insurance company. And there are new businesses like Wells Fargo, and Bank of America, and larger account size which they call Wallet is really driving their upside right now and their growth in earnings. Earnings projected to be over 110%, selling at only 14 times, we continue to hold this name. We like it very much. On the detractor side, Mercury Systems, MRCY, was down about 1%, 2% in December. They make mission-critical systems for Department of Defense, growing about 30% earnings per share and selling at 25 times. Company continues to make very creative strategic acquisitions to its portfolio, and this is really just adding valuable content and solidifying their prime contractor relationships, for example, going from chips and sub assemblies up the value chain to single-source full modules for various weapons programs. We still own the name and still expect significant upside to earnings going forward.

S2 10:48 Page 19 highlights sector weight changes from September 30 to December 31st. Changes were modest, with increases in industrial stocks offset by reductions in healthcare and consumer discretionary holdings. This concludes our prepared remarks. We've conducted a number of meetings with clients and prospects in recent weeks, and I'd like to share with you some of the questions we've been asked. First, now that the tax reform bill has been raised, have there been any changes to the way you analyze small-cap companies? Has there been any impact in the portfolios?

S3 11:32 Well, it really should benefit the small-cap space who, as a whole, are the highest taxpayers. And although it's very early in the process, what we're hearing is very positive commentary regarding capital decisions from our small-cap companies, adding more production lines, hiring additional shifts, possibly reopening plants to take advantage of many of the companies' markets. So this would be opposed to stock buybacks or dividends that some of the larger companies are opting for.

S2 12:06 Growth has had a great run in the past few years. Are you still able to find opportunities?

S3 12:12 Good question. We are. Certainly growth in the small-cap space within the context of a larger, more robust economy like we have today, maybe a 3% GDP growth, this really tends to have very long cycles. So our forward earnings for '18 and '19 continue to move higher with our companies.

S2 12:35 Finally, what macro issues are keeping you up at night? And have they had any impact on portfolio construction?

S3 12:44 Maybe another way to ask that question is what are we paying attention to from a risk-controlled standpoint or what are we worried about? Well, we certainly need to be very sensitive on what expectations are being built into our names. That's expectations on earnings growth, as well as expectations present in stock prices today. We manage this by getting to our price targets based on our upside to earnings, and not an assumption that that multiple expansion can occur. I think secondly, we need to pay attention to-- based on conversations with our companies, they're concerned that with-- they're concerned now with not having enough products on the shelf to meet demands versus before, of having too much. So I think this is maybe indicative of the positive opportunity set they see in front of them. But it is a business risk, and we need to be aware of that.

S2 13:41 Thanks, Scott. This concludes our remarks. Thank you for joining us. We think this is an opportune time to learn more about Friess Associates and our small-cap growth strategy. Our all-cap process has proven effective in isolating attractive ideas and identifying risks in small-cap stocks. We have an experienced, motivated team, and we've designed the organization for client success. Please contact us with any questions.

S1 14:14 Thank you very much, Scott and Gordon, for taking the time today. The webinar has now concluded and thank you for listening.

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