Looking Forward

Friess Associates market observations and insights

March 31, 2018

Earnings Strength Never Gets Old

Clichés are commonplace within investing circles. Heck, even the two words used to describe people and things related to major U.S. securities markets, "Wall Street," are so ubiquitously uttered that it's worthwhile to remind ourselves once in a while that their primary usage is in reference to an actual street. Full disclosure: Pick a page in this report, and you're likely to find evidence of our shared guilt.

Ah spring, "Sell in May and go away." Want some advice? "Don't fight the tape." And other words of wisdom, "No one ever went broke taking profits."

The emergence of trade tariffs in March as a threat to the extended period of global economic and stock market calm brought to mind some sayings that, while well worn, revealed the secret to their staying power via applicability. On the days when tariffs dominated the news, investors showed an inclination to ask questions later. As for now, they were shooting, pulling the trigger to sell anything perceived to be materially dependent on the Chinese market.

That prompted us to assess the eggs of each company we hold. Our strategy requires that we pursue companies that distribute their eggs in a reasonably diversified collection of baskets. Relying on Chinese consumers, the U.S. government or a big corporate customer to deliver a significant portion of a company's revenue is dangerous. We don't underestimate the risk such concentration poses due to sentiment, as reflected in the price-to-earnings ratio investors are willing to support, and possibly to future earnings.

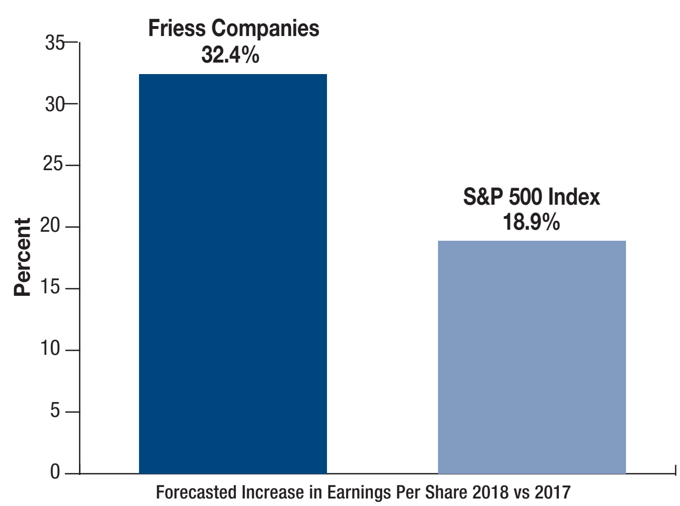
That's not to say we shy away from concentrating our commitments. It's just that earnings strength is the unifying theme that builds the portfolios we manage.

Boosted by corporate tax cuts, investors predict major earnings growth in 2018. Based on consensus estimates, the average company in the portfolios we manage is expected to grow earnings 32.4 percent this year. The average 2018 earnings growth rate for the S&P 500 Index is 18.9 percent.

First-quarter reporting season is expected to show a strong start to the year. Fifty-three of the 105 companies in the S&P 500 Index that issued updated guidance for first-quarter earnings raised forecasts, according to FactSet Research Systems. Companies are more likely to give early insight into bad news, so the breakdown is unusual. In fact, the number of companies issuing positive earnings guidance for the first quarter is the highest recorded since FactSet began tracking earnings guidance in the second quarter of 2006.

The Organization for Economic Cooperation and Development forecasts that global economic growth will accelerate slightly to 3.9 percent in 2018 from 3.7 percent last year. U.S. growth is expected to be 2.9 percent this year, up from 2.3 percent. So, economically speaking, the backdrop this year represents a continuation of the trends that contributed to positive investor sentiment in 2017.

Estimated Earnings Growth



Source: Consensus estimates from FactSet Research Systems Inc., as of March 31, 2018.

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.

Still, as we've already seen this year, economic expectations are far from the only things investors are thinking about these days. Stocks corrected abruptly in late January and early February when, within days of each other, the Federal Reserve telegraphed a slightly more aggressive stance on interest rates and the Labor Department reported a jump in average hourly earnings. Inflation, unworthy of concern for the better part of the nine-year-old bull market, is now a worry. Please see page 3 for an article on inflation.

Before February, it was two years since the last correction. It was also the longest period ever in which the S&P 500 Index didn't decline from its previous high point by at least 3 percent, according to CNNMoney.com.

With inflation concerns in the forefront, things that might not have registered a couple of quarters ago now get the market's attention. From revelations about Facebook user data spurring talk of new regulation in the technology sector to tweets critical of Amazon.com, investors appear to be gauging whether yesterday's market leaders should be tomorrow's. Other areas of growing uncertainty include valuations in general and potential for trade tensions to escalate. When it comes to the market's mood, it seems like predictability could be a luxury of the past.

All that might sound ominous, but it's just a long-winded way of saying we should expect things to get more choppy, with emphasis on should. The stock market is historically more volatile than it let on over the past couple years. Day-to-day give and take is normal. The period of nearly uninterrupted calm that ended in February was unprecedented.

Forecasts for companies in the financial sector reflect expectations for higher interest rates. Consensus first-quarter earnings estimates for financial companies increased the third most (11.3 percent) among the 10 sectors in the S&P 500 Index for which estimates increased between the end of December and the end of March, according to FactSet.

Likewise, analysts showed increased confidence in the earnings outlook for Green Dot Corp. (page 4) over the past three months. Green Dot is a unique bank in that it caters to people who don't utilize or only sparingly utilize traditional banking services. The U.S. population of its potential customers is estimated to be about 70 million.

Green Dot is best known for issuing prepaid cards, which over the years it helped expand from one-and-done cards such as gift cards into reloadable, repeat-use cards used for payroll distribution, tax services and other functions commonly associated with traditional financial institutions. Its experience and card-based banking platform infrastructure makes it an appealing partner for other companies, including Apple Pay and Walmart, that wish to issue branded card products. Green Dot enjoys all of the upside of higher interest rates because it doesn't pay interest on deposits.

Amid strong demand for trucking services, there's a dearth of drivers. A new mandate limiting the amount of time drivers can spend on the road puts further strain on the supply. Knight-Swift Transportation Holdings (page 5) is especially well-positioned to outmaneuver its competition. Knight acquired Swift to form what is now the largest truckload carrier in North America. By improving yields and realizing merger-related synergies, the company is able to raise driver wages and capitalize on demand.

Skechers USA (page 5) made a concerted effort in recent years to expand its international reach. Having stoked demand for its brand of casual lifestyle footwear, the company is leveraging years of infrastructure investments overseas into profitable international growth. Sales to foreign retail and wholesale customers accounted for 53 percent of revenue in the company's most recently reported quarter. The Manhattan Beach, California-based shoe company generated $4.2 billion in revenue in 2017.

Despite talk to the contrary prior to its completion, the recently passed omnibus spending bill included the largest increase in research spending in more than a decade. That's good news for Bio-Techne Corp. (page 4), which makes proteins, reagents and instruments used in the research and clinical diagnostic markets. Its customers include pharmaceutical and biotechnology firms, academic institutions, governments, hospitals and laboratories. Consumable products represent the vast majority of sales, generating recurring revenue. The company exceeded earnings estimates every quarter last year.

We continue to isolate the most earnings strength in the technology sector. Companies in the consumer discretionary and industrial sectors represent the next largest portfolio positions.

We appreciate your long-term focus and continued confidence. Your entire Friess team joins me in sending best wishes.

Scott Gates
Chief Investment Officer

Continued Growth Could Come at a Cost

General Mills in February told investors at a conference to temper expectations for current-year operating profit from a flat-to-up-1-percent range to a flat-to-down-1-percent range. Freight and logistics costs were mostly to blame. A month later, on its earnings call, the maker of Cheerios and Haagen-Dazs revised the revised forecast to a contraction of 5-to-6 percent. Higher commodity costs added to the profit-squeezing pressure.

Modest inflation has been a consistent theme throughout one of the longest economic recoveries on record. That could be changing.

The number of Americans seeking unemployment benefits is the lowest in nearly five decades. The Institute for Supply Management's manufacturing index in February registered its highest reading since May 2004. After an extended period of stagnant wages, these and other indicators raise the likelihood that companies will be forced to pay more to attract and retain workers, leading to higher consumer prices. While it remains to be seen, many economists expect recent tax cuts to add to whatever inflationary momentum already exists.

The world's major economies are enjoying synchronized growth. This is helping boost commodity prices, stimulating demand for services and leading to price increases.

Prices for materials such as steel, aluminum and copper were on the rise well before talk of tariffs emerged. Appliance maker Whirlpool Corp. estimates that rising steel prices alone could reduce profits by $250 million this year.

Higher costs can quickly show up in line items on balance sheets and income statements, eroding profit margins and impacting earnings results. Amid general inflationary trends, we look for companies with specific advantages that allow them to remain competitive and maintain healthy profit margins.

The trucking industry started reacting to driver shortages and new federal regulations (electronically monitored driver time limits) last year with price increases. Now the industry is negotiating forward contract rates for the holiday season in a tight market, leading to expectations that rates will increase as long as this dynamic remains in place. Knight-Swift Transportation Holdings and XPO Logistics benefit as higher prices more than offset higher costs for drivers and health care.

Amazon.com created what is arguably the world's most efficient order-fulfillment system, including a network of warehouses and its own logistics business. Still, higher input costs affect every business model.

Amazon's operating expenses jumped 28 percent in its most recently reported quarter. With employee headcount up 42 percent from the year before, the company's growth obviously contributed to expenses. Shipping costs, which increased 36 percent, played a role, too.

That said, it's estimated that as many as 60 percent of American households sport an Amazon Prime membership. The company recently raised its subscription service from $10.99 to $12.99 for the portion of its membership that pays monthly.

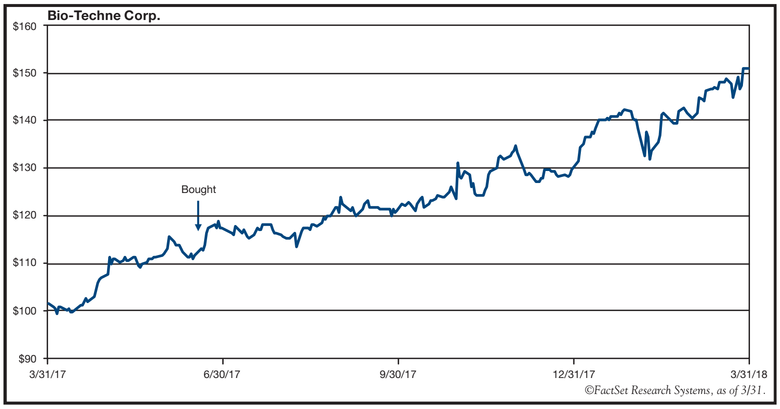
Netflix is spending up to build on its strategy of competing with major networks and studios by developing more of its own original content. Going toe-to-toe with Hollywood is expensive, contributing to the company's decision to raise the price of its most popular subscription plan by 10 percent in October. For the time being, demand for binge-watching appears inelastic: Netflix closed out 2017 with its strongest quarter of subscriber growth ever.

As lumber, steel and other material costs rise globally, construction project costs follow suit. At the same time, the Federal Reserve recently raised its benchmark interest rate one-quarter point and indicated it was likely to raise rates twice more this year, essentially making these types of projects less affordable.

D.R. Horton, which mainly builds and sells single family homes, guided to better-than-expected fiscal 2018 gross profit margins as lower interest expense and the ability to pass through costs as price increases more than offset higher labor and material costs. Rental equipment provider United Rentals is adjusting rental rates quickly to reflect higher equipment costs and new emission standards.

As inflation concerns rise, it's important to understand the drivers behind prices and their ultimate impact. Even more insightful from a stock-picking point of view like ours is what price tags for goods and services ultimately mean for individual companies that make and provide them. Our focus remains on finding investments with company-specific advantages that allow them to preserve profitability as they grow their businesses.

Bio-Techne Corp., TECH



Investors balked in mid-2016 when Bio-Techne made an acquisition that appeared to weaken the company's profit profile. It later became apparent that acquiring Advanced Cell Dynamics (ACD) amounted to adding a turbo-booster to Bio-Techne's formerly sluggish organic growth engine, and now investors appear to be past their previous grudge.

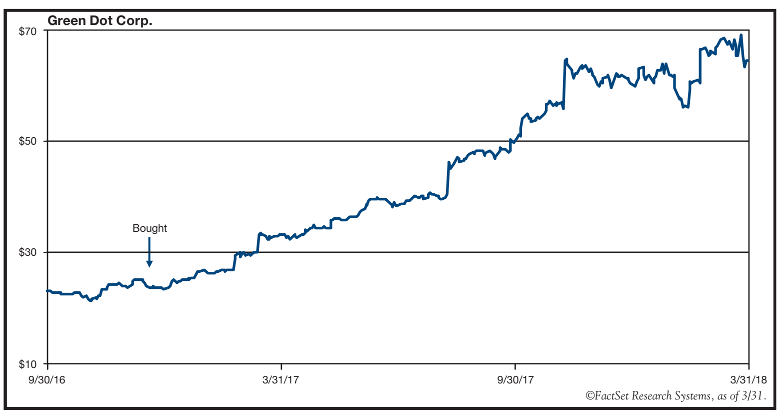
Nasdaq-listed Bio-Techne Corp. makes proteins, reagents and instruments used in the research and clinical diagnostic markets. Customers include pharmaceutical and biotechnology firms, academic institutions, governments, hospitals and laboratories. The company's broad product portfolio consists of more than 300,000 SKUs and 40,000 self-manufactured products. Consumable products represent more than 85 percent of Bio-Techne's product mix, generating recurring revenue. Revenue grew 13 percent to $599 million in 2017.

December-quarter earnings grew 26 percent, exceeding the consensus estimate by 11 percent. Net sales grew 17 percent, driven by 14 percent organic growth. ACD's organic revenue growth rate topped 40 percent, making it the driving force in the company's core biotechnology segment. Protein platforms grew by one-third organically. As for profitability, operating margins improved modestly (after excluding for a one-time charge).

Your team spoke with Chief Financial Officer James Hippel about the 15 percent of Bio-Techne's revenue that is tied to academic funding. The recently passed omnibus spending bill contained the largest research spending increase in more than a decade, with $3 billion in funding going to the National Institutes of Health, increasing the NIH budget by 8 percent. Higher research spending represents a sizable opportunity for Bio-Techne to add to its organic growth momentum.

Consensus estimates put Bio-Techne on pace to finish its fiscal 2018 ending in June with 17 percent earnings growth.

Green Dot Corp., GDOT



Seven percent of U.S. households, or roughly nine million, don't maintain an account with an insured financial institution, according to the Federal Deposit Insurance Corp. Another 20 percent, or more than 24 million households, hold checking or savings accounts, yet still go outside of the banking system for other financial products or services. Wall Street repeatedly underestimates how these large populations of unbanked and underbanked individuals positively influence Green Dot's bottom line.

Nasdaq-listed Green Dot Corp. provides prepaid cards and other financial services. Its retail distribution takes place through about 100,000 sites, including convenience, drug, dollar and grocery stores. Green Dot also provides access to its "Banking as a Service" platform for use with cards branded by customers including Apple Pay, Intuit, Uber and Walmart. Revenue topped $890 million in the 12 months through December, up 24 percent from the year before.

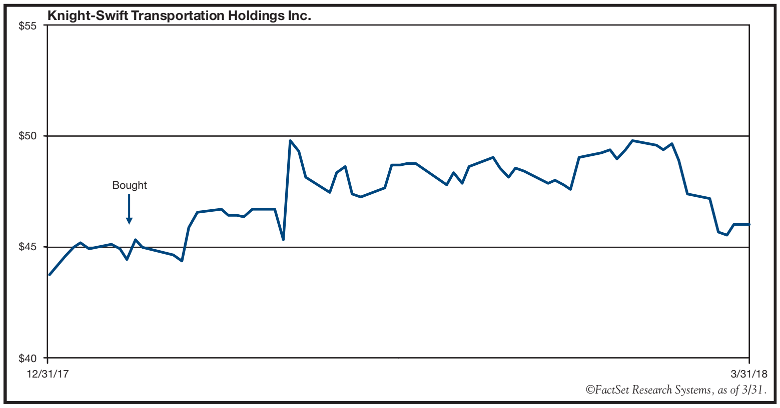
Green Dot surpassed the consensus earnings estimate in every quarter over the past three years. Most recently, the company grew December-quarter earnings 53 percent, exceeding expectations by 17 percent.

Green Dot generates revenue through transaction fees, account fees, interest on deposited funds and interchange (the issuer's portion of the fee charged to merchants when cards are used to make purchases). In addition to one-and-done prepaid cards, Green Dot derives recurring revenue from payment disbursement cards, payroll cards and mobile checking accounts, among other sources.

Your team spoke to Chief Financial Officer Mark Shifke about Green Dot's efforts to build its long-term customer base through direct deposit. The company incentivizes cardholders to tie direct deposit to their accounts by offering reduced costs, waived fees and enhanced features to linked accounts.

Based on the consensus estimate, Wall Street expects Green Dot to grow 2018 earnings 33 percent.

Knight-Swift Transportation Holdings Inc., KNX



Trucking capacity remains tight amid strong demand, driver shortages and new regulations. In a healthy environment for most operators, Knight continues to incorporate the assets and operations of Swift Transportation in an effort to accelerate profit growth.

Through the September 2017 merger, Nasdaq-listed Knight-Swift Transportation Holdings Inc. became the largest truckload carrier in North America, with about 18,000 tractors, 75,000 trailers, 9,100 intermodal containers and 4,700 independent contractors.

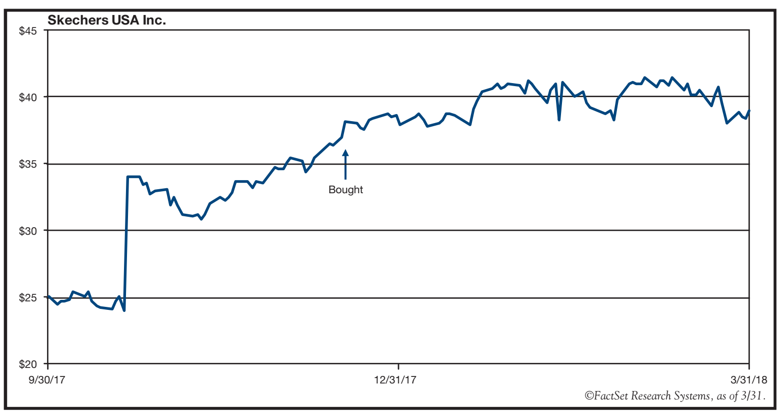
December-quarter earnings per share jumped to $0.47 from $0.29 a year ago, beating the consensus estimate by 18 percent. Results reflected progress on merger synergies and favorable developments in freight demand. More specifically, Knight-Swift was uniquely positioned to rationalize costs while benefiting from increased rates. The company reported that, in addition to robust market conditions, rate trends partly reflect the impact of the recent implementation of the Electronic Logging Device (ELD) mandate, which enforces driver time limits.

Your team spoke to Chief Financial Officer Adam Miller about strides being made in combining the two companies. Knight, historically among the best-in-class truckload operators, consistently achieved superior profit margins to Swift. Management believes there are material opportunities to close this gap, particularly in areas of purchased transportation, operating supplies and rental expense.

The company is focused on improving yields to help support driver wage increases amid tight labor conditions. Also, new opportunities could emerge as smaller competitors struggle to comply with ELD requirements. Knight-Swift announced it would acquire Abilene Motor Express, a truckload carrier with 400 trailers, during the December quarter.

Analysts predict that Knight-Swift will earn $2.31 per share on $5.4 billion in revenue in 2018.

Skechers USA Inc., SKX



Five years ago, Skechers wrote in the opening paragraph of its annual 10-K that its objective was to "profitably grow our operations worldwide." The company invested heavily to boost its international presence in the years since, including growing its global distribution network by 20 percent last year alone. With infrastructure in place and healthy demand for its products overseas, a profitable period of global market share expansion now appears to be afoot.

NYSE-listed Skechers USA Inc. makes a diverse collection of casual, lifestyle and performance footwear for adults and children. Skechers footwear is sold in the United States and more than 160 countries through department stores, 2,570 Skechers-branded retail stores and e-commerce websites. Revenue approached $4.2 billion in the 12 months through December, up 17 percent from the year before and representing an all-time company record.

Revenue grew 27 percent in the three months through December, led by a 40 percent increase in international wholesale sales. Domestic wholesale and global retail sales grew 12 and 26 percent, respectively. Combining wholesale and retail, international sales accounted for 53 percent of revenue in the quarter. Earnings jumped to $0.21 per share from $0.04 in the year-ago period, exceeding the consensus estimate by 58 percent.

The biggest international growth driver is China, where Skechers operates through a joint venture. Sales in China were just shy of $50 million in 2013. In 2017, sales in the country reached $575 million, topping management's initial forecast for the year by $75 million.

Amid all of this top-line momentum and the profit margin opportunities stemming from it, management and the board of directors demonstrated their confidence in Skechers' outlook by authorizing the company's first-ever share repurchase program.

Based on the consensus estimate, Wall Street expects Skechers to grow earnings 28 percent in the year ahead.

Viewing the Big Picture from the Bottom Up

Many investment managers formulate top-down forecasts and strategically allocate assets to best fit their predictions. Our process recognizes that economic data and geopolitical developments are pieces in an ever-changing, big-picture puzzle that is never completely solved.

Using fundamentals-based research as a guide demands that we assess the influence of broad macroeconomic changes on a company-by-company basis. The portfolios we manage take shape from the bottom up. Company-specific factors, with earnings growth potential topping the list, ultimately determine the collective result.

In the portfolios we manage, an increased commitment to technology or a decrease in portfolio turnover is not the result of a premeditated plan. We let decisions based on individual-company fundamentals dictate portfolio characteristics as much as possible. This allows us to migrate to pockets of earnings strength as the economic landscape evolves and company outlooks change.

For instance, the portfolios we manage show that we're currently comfortable with a notable commitment to the industrial sector. That doesn't mean we feel one way or the other about the sector as a whole. Positions in the portfolios we manage are like maps indicating the places in which we are able to locate earnings strength.

Drilling down to the industry level reveals that a significant portion of the assets dedicated to the industrial sector targets construction companies and equipment manufacturers benefiting from infrastructure spending related to energy production and communications transmission. Whether the sector's overall position represents a higher or lower concentration than an index position is a byproduct rather than a preconceived effort.

The portfolio's overall valuation also stems from our strategy's bottom-up perspective. We buy companies that we believe sell at reasonable multiples of earnings estimates, differentiating us from other growth investors willing to pay big premiums for growth. Our price-to-earnings ratios, which are typically less than 30 times forward earnings estimates at purchase, reflect the degree to which our research shows undervalued earnings growth and potential for valuation expansion as earnings growth is realized.

Still, the individual-company models we develop make no assumptions about valuation expansion, especially amid uncertain macro conditions. We assume that the denominator in the price-to-earnings ratio will fuel each holding's rise to the price targets that we set. We believe focusing our efforts on identifying companies for which our research shows the most potential to exceed consensus earnings estimates is the best way to achieve that goal.

Exhaustive, company-by-company research is the key to our approach. We hone our individualized earnings expectations for existing holdings and target companies by keeping in constant contact with executives, salespeople and others who interact with these companies. At Friess Associates, we use the term "trade check" to describe the interviews we conduct with company management teams, customers, competitors and suppliers. Trade checks include in-person company visits, trade shows, user conferences and discussions via phone.

We've collected research contacts for more than four decades, enabling us to develop an extensive, proprietary database of folks to call on. Continuously maintained for quality over the years, that database now consists of more than 20,000 contacts. Another database is populated with the insights we gather from each contact in order to facilitate real-time information sharing among research teammates.

We recognize that the big picture and the trends that shape it are important to consider when investing. We just think the big picture comes into better focus from another angle. Trends evolve, with different companies jockeying to position themselves to benefit amid shifting dynamics. That's why we're committed to consistently surveying the investment landscape from the individual-company level. Strategy, resources, execution and other company-specific factors establish each company's fundamental outlook and, ultimately, its value to investors.

Friess Strategy Highlights

- Rapidly growing companies
- Reasonable price-to-earnings ratios
- Focus on companies likely to exceed consensus earnings estimates
- Emphasis on under-researched, lesser-known companies rather than industry leaders
- Intensive and repeated contacts with company managements, customers, competitors and suppliers

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.

Artificial Heart Aims to Beat Previous Designs

The first artificial heart was transplanted and tested more than 80 years ago, so the concept of a man-made ticker isn't the first thing that comes to mind when one thinks of cutting edge developments. But, despite the artificial heart's lengthy history, just one model is currently approved for use in the United States and it's only intended to serve as a bridge to an eventual human heart transplant. Researchers at Oregon Health & Science University, a school responsible for the first artificial heart valve, seek a permanent mechanical solution to human heart failure. Simply designed, an alloy rod moving within a titanium tube does the work of the heart's lower chambers, feeding the lungs and sending oxygen-rich blood throughout the body. Unlike previous artificial hearts, the OHSU version mimics a human pulse, reducing risks related to continuous-flow designs. A combined controller and rechargeable battery pack powers the unit and must be carried by the user, but the researchers hope to hone their design to a point at which the power source can be implanted under the skin.

Tiny Tumbling Technology

Of the many questions to be answered before microscopic robots are one day deployed to perform medical tasks inside the human body, how these robots might traverse such a varied environment stands among the most vexing. Purdue University researchers believe their "microscale magnetic tumbling robot" could represent a viable solution. Called microTUM for short, the 400-by-800-micron (smaller than a pin head) robot tumbles end over end and/or sideways in response to a continuously rotating magnetic field. The tumbling motion gives the microTUM all-terrain capabilities that enable the robot to traverse uneven surfaces with greater success than other forms of motion that have been explored. The researchers, who published results of their work in the journal Micromachines, tested microTUM on a dry surface as well as in both water and silicon oil to evaluate its performance in environments of varying viscosity. The hope is to advance the technology to a point at which microscopic robots are able to deliver medicine to a targeted part of the body guided by imaging such as ultrasound.

Existing Drug Reverses Autism's Social Symptoms in Mice

A growing body of research shows numerous genetic risk-based commonalities between autism and cancer. In an effort to explore whether treatments could arise from potential connections, researchers at the University of Buffalo tested animal subjects to see whether an approved cancer-fighting treatment could positively impact social deficits associated with autism spectrum disorder (ASD). The research focused on a gene called Shank3. Shank3 deficiency has been linked to behavioral patterns associated with ASD in previous studies. In this instance, mice engineered to be deficient in the Shank3 gene were given low doses of romidepsin, an FDA-approved lymphoma treatment commercially known as Istodax, over three days. The mice showed material behavioral and social improvements that persisted for several weeks. That's significant because mouse model effects that measure in weeks can translate into years in successful human applications. Istodax is made by Nasdaq-listed Celgene Corp., a biopharmaceutical company based in Summit, N.J.

Potential Steel Alternative that Grows on Trees

Wood-based structural components in airplanes, automobiles and buildings? It could happen, at least according to some determined researchers at the University of Maryland (UMD). By processing natural wood a certain way, the UMD team developed a "super wood" that is 12 times stronger and 10 times more durable than natural wood. The resulting characteristics make the natural, renewable substance competitive with steel and many titanium alloys in terms of performance while offering considerable potential costs savings versus metals. Creating super wood entails boiling wood feedstock in a mixture of sodium hydroxide and sodium sulfite, a process that removes lignin, the organic polymer that makes wood brown and rigid. Next, the wood is pressed under heat, collapsing cellular walls and creating a collection of densely packed nanofibers. Super wood achieves its steel-like performance while weighing six times lighter than steel.

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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 March 31, 2018, Amazon.com Inc., Bio-Techne Corp., D.R. Horton Inc., Knight-Swift Transportation Holdings Inc., Skechers USA Inc., United Rentals Inc. and XPO Logistics Inc. represented 4.16, 2.01, 0.89, 1.53, 1.12, 1.56 and 1.53 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Amazon, D.R. Horton, Knight-Swift, Skechers, United Rentals and XPO Logistics at 4.52, 0.89, 2.11, 2.03, 2.09 and 2.05 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held Bio-Techne, D.R. Horton, Green Dot Corp., Knight-Swift, Skechers, United Rentals and XPO Logistics at 2.31, 1.49, 2.48, 2.40, 2.01, 2.09 and 2.03 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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