

Friess Small Cap Growth Q1 2018 Webinar Transcript

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Speaker Details:

S1 – Tracy Rogers, *Moderator*

S2 – Joe Fields, *Managing Partner for Friess Associates*

S3 – Scott Gates, *CIO and Managing Partner for Friess Associates*

Transcription results:

- S1 00:03** Good day, and welcome to the Friess Associates Q1 2018 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 now turn the conference call over to managing partner, Joe Fields, and CIO and Portfolio Manager Scott Gates with Friess Associates. Gentlemen, please go ahead.
- S2 00:27** Thank you, Tracy. This is Joe Fields. I'm the director of marketing and client service at Friess Associates. Thank you for joining us today. I am joined by our Chief Investment Officer, Scott Gates. We are set to review our organization and process and plan to focus most of our attention on discussing March quarter results. With that, let's turn to page four of the presentation. Friess ended the first quarter with \$1.3 billion of assets under management. Our small-caps strategy grew from \$110 million at the end of the year, to \$140 million at the end of the first quarter. Our small-cap fund was responsible for the majority of the \$30 million increase. Our small-cap growth fund ended the quarter with \$125 million in assets. Turning to pages eight and nine, Scott will give a quick review of our investment process. Scott.
- S3 01:39** Our investible universe for small-cap is in the \$200 million to \$4 billion dollar market-cap range. And our process further dictates our candidate pool. But generally speaking, what we want to see in our companies is a minimum 20% earnings per share growth, conservative PE that we can attach to that earnings 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 that earnings stream and surprise the street. For example, a new product, maybe a new market, maybe a change in the competitive landscape, and clearly an earnings upside conference call. If we flip to slide 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. 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 database of 20,000 industry contacts that we've developed over the last 20 years. We do about 100 of these a week, these phone calls, meetings, 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 the best decisions ahead of positive catalysts for our companies. All of this is done in real-time as these conversations and meetings 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.
- S3 03:42** Let me give you a quick example, maybe illustrate this better. There's a big transition going on in the optical networking space from 10 gigs to 100 gig speeds. Think of it as more traffic like video, that requires more bandwidth and greater speeds. Well, we have analysts talking to the carrier companies like Verizon and Comcast. Also the construction companies, laying the fiber, Dycom, Mastec. Others are focused on the service aspects of these networks, like Limelight Networks. They're also focused on the equipment enablers in the space, like Ciena. All the way to subsystem and component suppliers like Fabrinet, Lumentum, Avago.

What we're doing is really sharing and leveraging the information in real-time across several sectors, multiple analysts, and talking to companies that I said all up and down that market-cap spectrum.

- S2 04:44** Executing the process that Scott described yield the performance results shown on page 15. The first quarter was volatile with both the geopolitical issues in the street getting ahead of the earnings reports due to potential GDP growth. The Friess small-cap composite grew 0.7% in the March quarter compared to 2.3% advance in the Russell 2000 Growth Index. An underweight position in healthcare was primarily responsible for the 160 basis point relative performance difference. The Composite grew 22.7% in the 12 months through March versus 18.6% for the Russell 2000 Growth. Longer term over the three, five, and inception periods, saw our small cap strategy outperforming the benchmarks by well over 500 basis points each period during the average. During the March quarter, our technology sector was the largest portfolio position followed by industrials and consumer discretionary. Holdings from the industrial sector contributed the most to relative performance, while the healthcare sector, although a modest contributor to their absolute performance, weighed the most on performance versus the index. Page 18 lists the top contributors and detractors to the March quarter performance. Scott, can you review a few of these names?
- S3 06:30** So let's look at the top contributors, and I'll just focus on two top contributors, two top detractors. Upland Software, a provider of cloud-based enterprise work-management software reported triple December quarter earnings versus a year ago period. This exceeded the consensus estimate. Revenue increased 44% reaching a company record. New customer wins and strategic acquisitions really drove these results. We still own Upland. Tabula Rasa Healthcare, TRHC, the provider of patient-specific data solutions to improve outcomes and reduce risk in medication regimes. They grew December quarter revenue 61% exceeding expectations. They also provided better than expected revenue guidance for 2018. We still own this name as well. On the detractor side, Winnebago industries, WGO, a manufacturer of motorized and towable recreational vehicles grew 44% in the February quarter. This exceeded consensus estimates, but shares traded lower with concerns surrounding dealer inventory and order backlog in the towable segment, primarily from their competitor, and we ended up selling Winnebago to fund a new opportunity. Heska, HSKA, excluding a one time charge the maker of diagnostic veterinary products grew earnings 37% in the December quarter. And a modest 2018 revenue guidance disappointed investors whose forecast showed more pronounced optimism for new products than what the company had scheduled to introduce. We ended up selling Heska to fund a new opportunity with a more promising earnings outlook.
- S2 08:28** Thanks, Scott. The chart on page 19 highlights the sector weight changes on a quarter-by-quarter basis. The changes were modest with increases in the financial sector offset by reductions in technology. Our process continues to generate strong forward earnings growth in our holdings. On page 21, you will see our forward earnings growth expectation for the portfolio of 24.8% on a forward basis while the index growth rates are substantially lower. For that outsized earnings growth, we were paying reasonable valuations. We currently own 53 holdings in our small-cap portfolio, and the market median of \$1.6 billion, and a weighted average market cap of \$2 billion. These market caps ensure this is a true small-cap portfolio. This concludes our prepared remarks, but as we've been out traveling, having meetings with clients and prospects, I'd like to share with you some of the questions we've been asked in our travels. First, given our all cap research approach, why do we believe the small-cap area has so much potential going forward?
- S3 10:02** Well, the core of our investment strategy is research legwork, talking to companies, kicking tires, interviewing customers and competitors. And in terms of access and the ability to develop actionable insights from the bottom up, the small-cap space is the most fruitful place to hunt. Small-cap investing also offers more variety and by extension, the ability to find companies that stand out from the crowd in terms of success. We're catching companies at an early age of their evolution. Some companies will rocket on that small-cap stage, while others will go out of business. So when you look at the index like the S&P, for example, the S&P 500 Index, there's a certain level of consistency in terms of operational quality. That's certainly not the case in small cap. Historically, somewhere between one in four, one in five companies in the Russell 2000 Index, is considered a non-earner, which is a nice way of saying, they are losing money. So

again, that small-cap space just provides more opportunities for us to isolate companies that differentiate themselves with earning success.

- S2 11:19** Thanks, Scott. Next question is in reference to risk controls. And what are the risk controls inherent in our process? And what are the results of that risk management?
- S3 11:36** Well, our strategy really puts company specific risk above other risk considerations. What we want to do is avoid share price declines from negative business outcomes. So as a result, company-level fundamental research is emphasized as a critical risk management tool in our process. Given our individual company focus, we typically avoid companies with earnings prospects heavily dependent on unpredictable macro factors. Valuation risk is another area we stress. Very important today. We try to limit the outside risk by purchasing companies that sell at very reasonable multiples of their earnings estimates. The same philosophy carries into decisions on selling securities. Since we believe valuation risk increases as price-to-earnings ratios rise, we generally establish price targets that are on the conservative side.
- S3 12:33** As active investors, we're also focused on minimizing investment risk. We want to hold companies with improving fundamentals, so we don't hesitate to sell a company when it experiences a negative event that proves us wrong. We act to limit opportunity cost by switching that name into a new holding with better upside potential. Sector risk is also managed. Portfolio construction occurs from the bottom up, without specific targets for sectors or industry. We capitalize on variety within sectors and promote diversification by limiting industry representation to 15% of assets. Finally, liquidity risk. Position limits are based on daily trading volume. Initial positions are typically limited to 2% of assets at purchase, and individual holdings are generally restricted from going beyond 5% of assets. If we look at page 17, this shows our ability to add value and manage risk properly in both up and down markets. I'll take the last question that we've heard quite a bit, for Joe. Finally, we've seen a meaningful-- we're seeing meaningful flows in the small-cap strategy. What types of clients are investing?
- S2 14:04** We have seen some stronger flows in the last six months, and as we launched our small-cap mutual fund June 1st of 2017, we're seeing more investors that are primarily institutions, family office, and high-net worth individuals. Many of these clients are being sourced by investment consultants and financial advisors across the country. We're also chefs that eat our own cooking, we like to say. So we continue to see our Friess teammates and ourselves show the confidence in our small-cap strategy by investing in it. In fact, as you aggregate the AUM at our firm, our current and past employees are the largest shareholder group in our mutual fund family. Thank you, as this concludes our remarks. We appreciate you joining us, as we believe this is an opportune time to learn about Friess Associates and our small-cap growth strategy. Our all-cap process has been very effective in isolating attractive ideas among small-cap stocks. We have an experienced, motivated team. We're positioned to support the organization for client success. Please do not hesitate to contact us with any questions you may have.
- S1 15:43** Thank you very much, to both Joe and Scott, for taking the time this afternoon. The webinar is now concluded, and thank you all for listening.

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The Small Cap Composite includes all discretionary accounts that invest primarily in securities with market capitalizations of less than \$4 billion. The Small Cap Composite was created in accordance with GIPS® standards as of January 1, 1993, the earliest possible adoption date. The inception date of Friess Associates' management of the Small Cap Composite is December 31, 1981. There are no non-fee paying accounts in the Composite. To receive a presentation that complies with the GIPS® standards, contact David Marky at Friess Associates, P.O. Box 4166, Greenville, DE 19807 or dmarky@friess.com.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell Investment Group is the source and owner of the Russell Index data contained or reflected in this material and all trademarks and copyrights related thereto.

As of March 31, 2018, the Friess Small Cap Composite's average annual total returns (including Friess Associates' management fee of 1% of assets annually and the reinvestment of dividends and all brokerage fees) for 1-, 5- and 10-years were 22.05, 17.74 and 7.60 percent, respectively. Over the same time periods the Russell 2000 Growth Index's average annual total returns for 1-, 5- and 10-years were 18.63, 12.90 and 10.95 percent, respectively and the Russell 2000 Index's average annual returns were 11.79, 11.47 and 9.84 percent, respectively. You cannot invest directly in the Composite or the Index.