

Looking Forward

Friess Associates market observations and insights

September 30, 2018

Strength Eliminates Need for Further Accommodation

It's not so much what the Federal Reserve Bank (the "Fed") said in the statement issued after its Open Market Committee meeting on September 26. The usual stuff, like the reminder about the Committee's statutory mandate and the update on the risks to the economic outlook, was there in the familiar, dryly delivered pronouncement. But something was missing.

Ever since the U.S. economy began emerging from the Great Recession, the Fed made it regular practice to follow up its get-togethers by assuring us of its support. When it came time in December 2015 to temper years of stimulus with the first rate hike of its current series, the central bank made sure to point out that monetary policy remained "accommodative." The word appeared in every statement subsequently issued.

Then came that September afternoon when it didn't. Training wheels are off. Flying without a net. We, investors, are on our own. Good, bad, nonevent – in the complicated relationship between Fed policy and market sentiment, the implications are open to interpretation.

To say it's a nonevent to us would be simplistic. Inflation, employment and interest rates wield powerful influence in shaping the environment in which companies conduct business, so of course they influence our perspective. But, by interpreting their influence from the individual-company level up, changes in macro-level factors don't prompt us to make wholesale changes in the way we view the companies we hold.

Like any other interested investor, we hold an opinion on the Fed's current course. The way we see it, the reasons behind the Fed's action are cause for continued optimism. The Committee collectively estimates 3.1 percent growth in gross domestic product (GDP) this year, followed by 2.5 percent in 2019. As of the meeting, employment was considered "full."

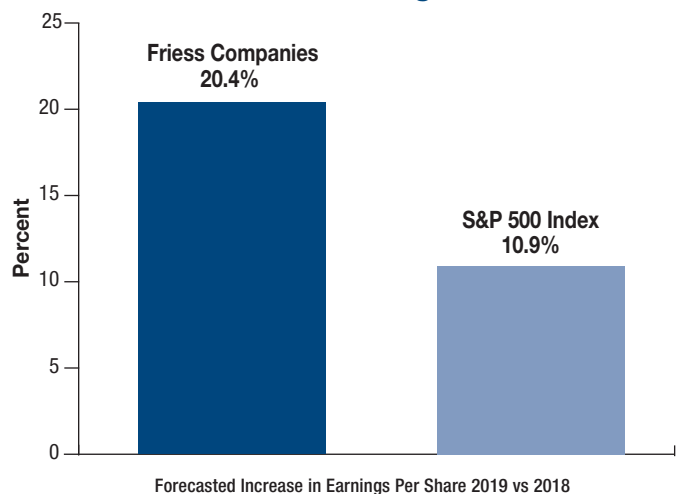
Since the last meeting in August, the labor market "continued to strengthen" and economic activity "has been rising at a strong rate," according to the statement's first paragraph, which includes one more "strong" and a "strongly" before it ends.

Less obvious is the important role current Fed policy plays in staving off inflation. While market sentiment was mostly upbeat in recent months, it's worth recalling that stocks were in correction territory as recently as February, when inflation concerns weighed on the market's mood. In these pages last quarter, we listed companies, including Deere & Co. and United Parcel Service, that discussed inflation as a rising burden during earnings calls.

Inflation-fighting efforts appear to be warranted, and the Fed continues to be successful in engineering its 2 percent inflation objective. So far, so good.

That attitude seems to be general consensus among investors, who continued to bid share prices higher in the just-completed September quarter. The period was the S&P 500 Index's strongest quarter since the final three months of 2013. On August 22, the current bull market became the longest on record since World War II, according to CNBC.

Estimated Earnings Growth



Source: Consensus estimates from FactSet Research Systems Inc., as of September 30, 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.

A lot of the credit goes to ongoing enthusiasm regarding earnings. Companies continue to report big earnings growth numbers, boosted by comparisons to a year-ago period when the corporate tax rate was considerably higher.

Based on consensus earnings estimates, the companies in the S&P 500 Index are expected to report third-quarter earnings growth of 19.3 percent. Revenue growth is expected to be a solid but more modest 6.9 percent, according to FactSet Research Systems.

FactSet's data show that all 11 sectors in the index are projected to grow third-quarter earnings versus the year-ago period. Forecasts for seven sectors predict double-digit growth, with the biggest gains expected to come from the energy, financial and materials sectors. If the index delivers on the forecasts, it will trail only this year's previous two quarters as the S&P 500 Index's fastest earnings growth since the first quarter of 2011.

While we're excited about near-term earnings prospects, we believe it's important to gain insight into 2019 trends as the final earnings seasons of this year unfold. The corporate tax cut went into effect as the bull market marked its ninth anniversary. Assuming the market extends its run past the 10-year mark, earnings growth will appear far less flashy as year-over-year comparisons become apples-to-apples in terms of tax rates.

Current forecasts put the S&P 500 Index's 2019 growth rate at 10.9 percent, or a little more than half of expected growth for this year. Even with that drop-off evident in the index, we're encouraged to see that an environment that offers ample opportunity to find above-average growth appears likely to continue into next year. Based on consensus estimates, the average company in the portfolios we manage is expected to grow earnings 20.4 percent next year.

RingCentral (page 5) is growing at an above-average rate. The company, which provides business customers cloud-based communications and collaboration solutions, grew revenue by more than one-third to \$581 million in the year through June. In its June-quarter earnings release, which detailed RingCentral's ninth consecutive quarter of expectation-beating results, the company's chief executive stated that recent growth positions RingCentral well to achieve its goal of raising revenue to \$1 billion in 2020.

Synergy Research Group counts RingCentral as the market share leader by revenue and subscribers in the Unified Communications as a Service (UCaaS) market, which Synergy estimates is growing nearly 30 percent per year.

Harris Corp. (page 4) is on the cutting edge of communications in a different field. A communications pioneer, the company established the first hotline between the White House and the Kremlin following the Cuban missile crisis. Harris is a critical contractor

used by our government, making everything from tactical radios and night-vision goggles used by soldiers to optics and sensors used on satellites for intelligence gathering and weather monitoring. Its customers include commercial satellite companies as well.

Contracts provide insight into future revenue trends. Harris, which generated \$6.1 billion in revenue in its most recently reported 12 months, showed \$5.2 billion in backlogged orders at the end of June.

After a multiyear absence from the equity market, BJ's Wholesale Club (page 4) returned to the New York Stock Exchange in late June. The company improved profitability during its years as a private company, and brought in experienced leadership. BJ's new chief executive made it a priority to establish an identity for the warehouse club operator that better reflects its core customers.

Recognizing the typical BJ's customer is more value-minded than counterparts at Costco and Sam's Club, BJ's plans to build on the strength of its higher-profit private-label offerings, which currently generate about 20 percent of revenue.

Limelight Networks (page 5) offers technology to optimize data flow, an area of great interest to content providers as growing mountains of data strain networks, reducing speed and eroding quality. The company's content delivery network services address issues related to streaming music, television and video games that result in slow speeds or buffering.

Limelight also offers what it calls edge cloud services, which eliminate delays inherent in traditional cloud computing environments. The company operates a private fiber network separate from the Internet, enabling it to distribute traffic in a way that optimizes performance for Limelight customers.

We continue to isolate the highest concentration of earnings strength in the technology sector. Consumer discretionary and health care holdings comprise the next largest firm-wide portfolio positions.

Thank you for your confidence in our research-driven investment approach and the team that employs it.



Scott Gates
Chief Investment Officer



Big Differences Among Smaller Companies Invite Active Investigation

Small companies play a big role in our investment process. In addition to being candidates for the small- and all-cap portfolios we manage, they're a vital research resource due to their position on the economy's leading edge. Insights we gather at the small-cap level regularly prove useful even in our investigations into the market's largest companies.

Research among smaller companies can make a real difference for active, bottom-up investors like us. That's why we're surprised to see an increasing willingness in the indexing crowd to try to push the indexing argument far into the small-cap space. While we believe every market-cap category offers opportunities to outperform through active management, we think investing through an index-based, small-cap product means ignoring some of the clearest signals the market offers to pick one stock over another.

The emergence of exchange-traded funds, or ETFs, is a major factor in the growth of passive strategies. ETFs hold baskets of securities like mutual funds, but trade intraday like stocks. According to Forbes, there was \$3.4 trillion held in U.S.-listed stock ETFs at the end of this year's first quarter. The iShares Russell 2000 ETF is the largest small-cap ETF with nearly \$50 billion in assets under management, Bloomberg data showed at the end of September.

The problem with blindly buying a version of any index is that the construction of the index doesn't fully incorporate quality measures. At the very top of the market-cap scale, differences in quality aren't always glaring. Moving down in market cap, the potential to outperform grows as the opportunities to differentiate expand.

Consider that the Russell 3000 Index consists of about 3,000 stocks and represents approximately 98 percent of the U.S. equity market. The Russell 2000 Index is a subset of that index consisting of the smallest 2,000 or so companies in the group.

That's a big pool, and it's filled with variety. As fundamentals-driven investors, the most important form of variety we look for is the wide range of operational potential among companies. Given where smaller companies stand in terms of their corporate lifespans, a significant portion of companies with uninspired fundamentals is a persistent characteristic of the small-cap indexes. Components of the S&P 500 Index are required to be profitable, among other minimum financial standards.

Jefferies compiled statistics going back to 1985 for insight into profitability trends among smaller companies. Consistently, over a span of more than 30 years, the results showed that about one out of five companies in the Russell 2000 Index fell in the non-earner category, meaning consensus estimates forecast a loss in the year ahead. Based on consensus estimates, analysts expect 26 percent of Russell 2000 Index companies (for which estimates are available) to lose money this year, according to FactSet as of September 28.

Passive investing is buying yesterday's winners, which can end up being over-inflated and fundamentally challenged stocks. Individual companies that aren't bought on their own merits are lifted by bulk buying and, we believe, that can make indexes more informationally inefficient over time. When markets move higher because of loosening monetary policy, corporate tax reform or other macro events, this can become even more pronounced.

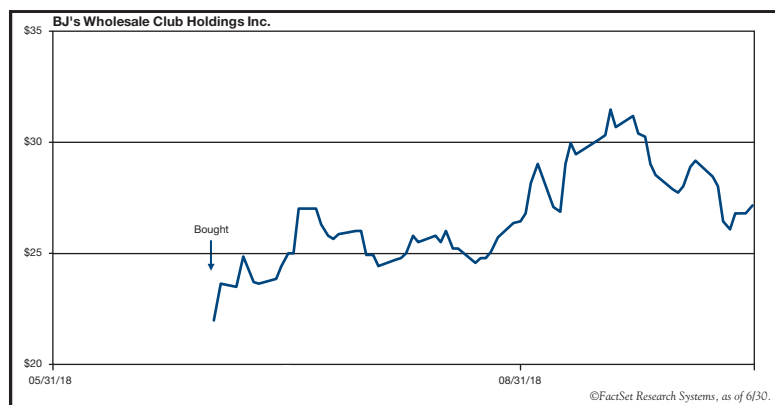
We believe that kind of situation puts stock pickers in a position to generate excess return while avoiding undue risk, resulting in strong risk-adjusted performance. Our experience shows that using earnings growth potential and valuation discipline to identify promising opportunities and to avoid potential pitfalls may be especially effective in the small-cap space.

We gather actionable insights by staying in touch with these companies and reaching out to third parties that are part of their food chain. We use our data points to build a research mosaic that serves as the basis of our internal earnings forecasts. Smaller companies generate less attention among sell-side analysts and the estimates that do exist tend to show higher dispersion, contributing to the odds that we might develop an edge.

Researchers performing legwork, trading portfolio positions and the other moving parts associated with active management do increase costs. Our goal is to generate results that make the costs worthwhile. Stocks move for all kinds of reasons from one day to the next. Over the long haul, however, we believe stock prices reflect the individual merits of the companies they represent.

We don't believe in accepting what any index happens to offer. Thanks for embracing our active, fundamentals-based style.

BJ's Wholesale Club Holdings Inc., BJ



first quarter for which analysts established earnings estimates since BJ's initial public offering. The company exceeded the consensus estimate by 16 percent.

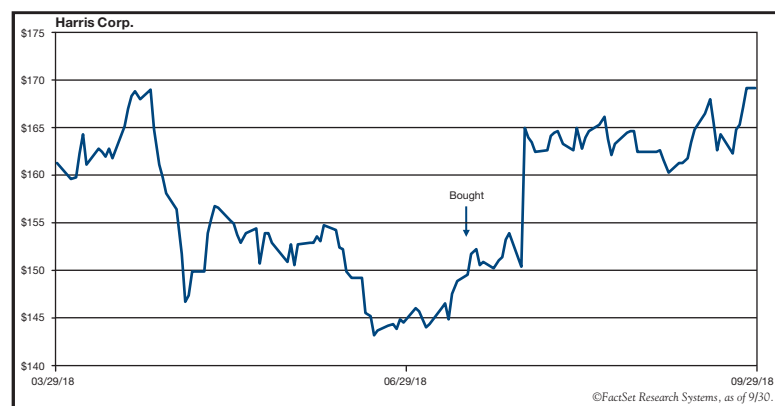
BJ's new chief executive described the company as being in the very early stages of a transformation. Hired in 2016, Chris Baldwin previously held leadership posts at Hess Retail Corp., Kraft Foods Group and The Hershey Co. Your team met with Mr. Baldwin, whose strategy revolves around establishing an identity for BJ's that better reflects its core customers.

BJ's is not the biggest warehouse club chain, with Costco and Sam's Club boasting store counts more than twice as large. BJ's differs in that it generates a significantly higher percentage of revenue from fresh food than its competitors. BJ's customers tend to seek value and to visit more frequently.

BJ's private label products represent about \$1 out of every \$5 in sales. Current initiatives include increasing private label penetration, simplifying merchandizing, improving procurement and better utilizing floor space. The company is also embracing new technology to aid in customer acquisition, marketing, pricing and other data-driven undertakings.

The consensus earnings estimate for BJ's this year is \$1.25 per share, which analysts expect to grow 19 percent next year.

Harris Corp., HRS



vision goggles, and electronic systems for avionic and maritime military applications. Other products include antennae, sensors, payloads, optics and related technology solutions that are used for gathering intelligence from space, supporting ground-based radar and providing insights on weather activity.

Engineers account for 45 percent of Harris employees. Customers include all branches of the U.S. military, agencies such as the N.O.A.A., F.B.I. and N.S.A., foreign governments such as Australia and Canada, defense contractors such as Boeing Co. and Northrop Grumman Corp., and satellite companies such as Iridium Communications and Sirius XM Holdings. Revenue reached \$6.2 billion in the 12 months through June.

Harris grew June-quarter earnings 19 percent, capping off a fiscal year in which it topped the consensus estimate in each quarter. Backlogged orders totaling \$5.2 billion provide visibility into future revenue trends. Your team met with Chief Financial Officer Rahul Ghai, who shared insights on defense budget increases related to tactical radio upgrades planned for the Army and Marine Corps.

Your team bought Harris at about 19 times earnings estimates for the fiscal year ending June 2019. Based on the consensus estimate, Wall Street predicts Harris will grow earnings 21 percent in the fiscal year.

BJ's is back. After being acquired by private-equity investors in 2011, the big-box retailer returned to the stock market earlier this year with new leadership and a strategy to restore growth. Early results are promising.

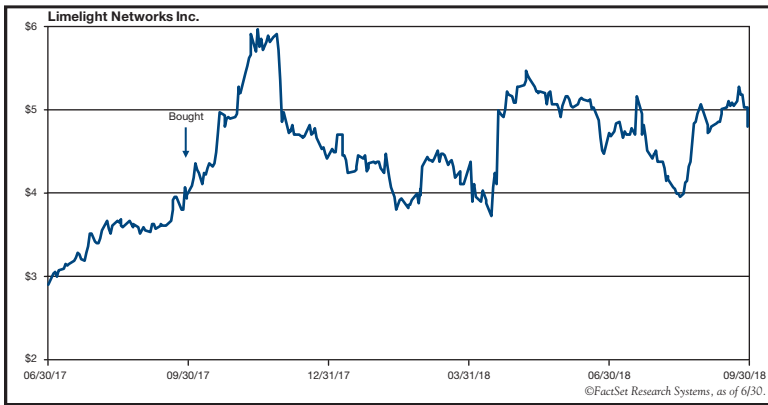
NYSE-listed BJ's Wholesale Club Holdings Inc. is a warehouse club operator with more than five million paying members. The company operates 215 stores in 16 states, capturing about 40 percent of the warehouse club market in the Northeast. Forecasts predict BJ's revenue will approach \$13 billion this year.

The three months through July represented the

Establishing the first hotline between the White House and the Kremlin following the Cuban missile crisis helped make Harris a communications contractor of historic note. The company's commitment to technological advancement in the years since burnished its reputation and expanded its capabilities, positioning Harris to play an important role in the security of the United States and its allies for years to come.

NYSE-listed Harris Corp. is a technology-driven defense contractor that specializes in communications equipment, electronics, and space and intelligence systems. The company makes tactical radios, night

Limelight Networks Inc., LLNW



Data traffic online keeps accelerating. As consumers stream online shows, real-time sports and multi-player games on their mobile devices, patience for slow connections runs thin. Limelight's platform is uniquely able to meet high expectations by leveraging a global network and technologies that get content fast and close to the people that want it.

Nasdaq-listed Limelight Networks Inc. provides high-performance content delivery network (CDN) services. Limelight digitally delivers content for traditional and emerging media companies in fields ranging from television and radio to video games and

software. Sales grew 13 percent to \$197 million in the year ended June.

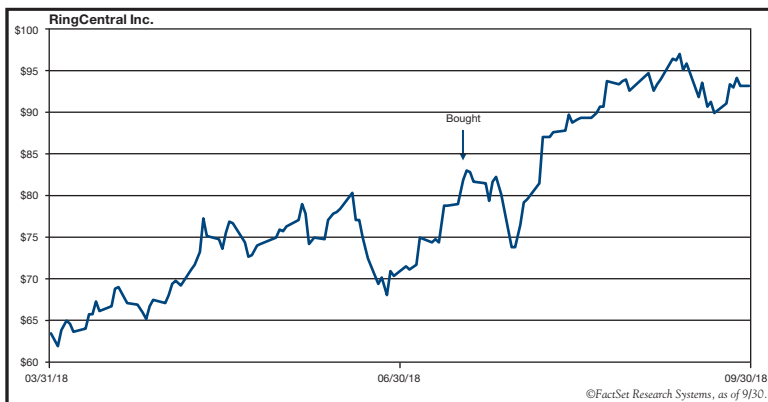
June-quarter earnings grew 33 percent, exceeding the consensus estimate. Revenue rose 11 percent, driven by video delivery services. Nearly half of revenue now comes from video delivery, where we believe Limelight is ideally positioned to capture over-the-top video traffic coming from Hulu, DirecTV Now and others. The company's expansive network allows it to meet demand for high-quality video delivery without buffering issues.

Profit margins expanded year-over-year thanks to improvements in software, infrastructure optimization and leverage on higher revenue. In particular, the company benefits from emerging demand for high-margin "edge compute" services, where computing power is put at the edge of the network to greatly speed up processes and reduce latency.

Your team spoke with Chief Executive Bob Lento regarding the company's new real-time streaming product. Existing technology suffers latency of more than 30 seconds in most cases during streams of live events, making for a poor viewing experience. Limelight's new technology eliminates this problem, enabling organizations to stream live video to anywhere in the world in less than one second.

Based on the consensus estimates, Wall Street expects Limelight to grow earnings 47 percent this year.

RingCentral Inc., RNG



According to Synergy Research Group, the Unified Communications as a Service (UCaaS) market is growing nearly 30 percent per year. Small and large companies are migrating updated phone systems to the cloud due to versatility, enhanced options and cost effectiveness. With a leading market share position, RingCentral's growth is dialed directly into these trends.

Nasdaq-listed RingCentral Inc. provides enterprise communications and collaboration solutions through the cloud. RingCentral combines mobile-first voice, video conferencing, messaging, team collaboration and contact center solutions on an open platform at global scale. Easier to manage and more flexible and

cost-efficient than legacy on-premises communications systems, RingCentral's cloud solutions are aimed squarely at today's mobile workforce. Revenue increased 34 percent to \$581 million in the 12 months through June.

June-quarter revenue also jumped 34 percent, helping push adjusted earnings to \$0.19 per share versus \$0.04 a year ago. Results exceeded expectations, led by software subscription revenue growth of 32 percent. The company's sales to enterprise customers surged as new large customers embraced cloud systems and existing customers widened the reach and options of services used.

Your team spoke with Chief Financial Officer Clyde Hosein regarding the sustainability of current growth rates. RingCentral boasts an estimated 20 percent share of the UCaaS market right now, but that still represents less than 10 percent of the total market dominated by legacy and hybrid equipment and solutions. The company posted its fastest bookings rate in nearly two years and landed the largest deal in its history during the quarter.

Based on the consensus estimate, RingCentral is expected to grow earnings 30 percent this year.

Trends Can Spark Ideas, But Decisions Depend on the Details

A trend, as they say, can be a friend. Conversely, there are times when prevailing conditions amount to a headwind. Taken alone, neither situation constitutes grounds for making one investment decision or another.

From growth in mobile technology and data analysis to advances in food science and genetics, broad, long-term trends influence the business prospects of virtually all of the companies we hold. Still, by themselves, trends are not material considerations within our investment approach beyond defining groups of potential investments worth investigating.

Secular trends evolve, with different companies jockeying to position themselves to potentially 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.

The basic premise of our investment strategy is that earnings performance is the most important fundamental factor in determining each company's share price. In other words, earnings drive stock prices. Exhaustive research is the key to our earnings-driven approach. We develop individualized earnings expectations for every existing holding and target company by keeping in constant contact with people on the frontlines of these companies and others who interact with them.

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.

The Friess research team conducts repeated trade checks each day 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.

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

Once we use this system to establish internal earnings estimates, we focus our attention on the companies with rapid growth prospects, sound fundamentals and solid balance sheets, including low debt and high returns on equity. We also demand a timetable of near-term growth catalysts, such as a new product launch, management team or market opportunity, likely to drive earnings in excess of consensus expectations.

We set price targets based on our estimates and price-to-earnings ratio expectations. Our belief that earnings growth plays the primary role in setting share prices doesn't mean we chase growth at any price. We aim to own companies before their success is fully reflected in their stock prices.

Our price-to-earnings ratios, which are typically less than 30 times forward earnings at purchase, reflect the degree to which our research shows undervalued earnings growth and potential for valuation expansion as earnings growth is realized. We buy companies that we believe sell at reasonable multiples of earnings estimates, differentiating us from other growth investors willing to pay a big premium for growth.

To keep the portfolios we manage stocked with our best ideas, we challenge our original assumptions about a holding and compare it to available alternatives. 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. The idea is to replace good ideas with great ones.

This "forced displacement" process triggers a sale when assets from an existing holding are needed to fund the purchase of a new, more promising investment opportunity. We also sell an existing holding when it reaches our price target, its fundamentals deteriorate or we believe Wall Street is overly optimistic about its prospects.

Friess Investment 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.

Tooth Talking with the Molar Mic

For U.S. Airforce Pararescuemen, communications equipment is a critical tool in successfully completing rescue operations. But even the best traditional equipment isn't totally reliable given conditions in the high-risk combat and humanitarian environments in which they operate. As a result, the Air Force is betting on technology designed to enable clear two-way audio communications that won't be disrupted by noise generated when parachuting at high altitudes, hovering in helicopters or navigating open water. Sonitus Technologies recently announced a multi-year agreement with the Defense Department to continue developing technology that the company nicknamed Molar Mic, a device with the functionality of a miniaturized headset that's clipped to a user's back teeth. Molar Mic consists of a mini microphone for speaking and a speaker-transducer for hearing via bone conduction. By locating the device internally and employing the user's teeth and jaw to create a new auditory path, both speaking and hearing occur with minimal intrusion from external noise. Successful deployment in the Air Force could lead to expansion among other branches of the military as part of a broader Defense Department program.

Passive Way to Get More Out of Spray

Despite all the sophisticated equipment employed in modern-day agriculture, researchers estimate that just 5 percent of liquids sprayed on crops stick to their intended targets. The rest, with about half lost to drift and the other half bouncing off crops, can be a waste of farming outlays and a source of pollution. MIT researchers recently offered a straightforward way to greatly improve liquid application performance. By suspending mesh just above crops, the team was able to reduce incoming drops into fine droplets, measuring just one-tenth of a millimeter in diameter, vastly increasing adherence. Mesh offers added benefits, including reducing stress on crops by serving as a buffer in rainstorms. Farmers can also reduce drift, though which pesticides and other chemicals waft into a neighboring farm or other unintended location, by using a conventional sprayer to produce larger drops onto the mesh below. The MIT team believes the approach makes sense in other applications, such as cooling towers common to chemical and power plants.

One Man's Trash

Lignin, lignin – what to do with all this lignin? In general, paper companies throw away the organic polymer that is responsible for making plants and trees rigid as a waste byproduct of the paper-making process. Researchers at the University of Delaware, recognizing that lignin boasts molecular properties similar to certain petroleum-based polymers with broad commercial uses, believe lignin deserves to stick around rather than take up space in landfills. After breaking down the wood component into molecular fragments used to synthesize new materials, in this case sticky ones, the UD team created a pressure-sensitive adhesive, or, as folks outside the lab like to call it, tape. Early results were promising, with the lignin-derived tape performing as well as commercially available tape under the Scotch and Fisherbrand brand names, according to UD. With additional engineering, researchers say they can tweak characteristics for different performance levels and kinds of tape. Lignin, of course, is renewable and, with continued research into possible uses, could reverse the flow for papermakers from cost to revenue stream.

Permanent Relief for Chronic Nasal Congestion

Is nasal congestion a chronic issue for you? Perhaps you should consider remodeling. That's what the folks from Aerin Medical are likely to recommend, assuming you score high enough on the nasal obstruction symptom evaluation, or "NOSE" for short. Nasal obstruction typically stems from enlarged tissue in the nasal valve leading to narrowing. There are basically two options for relief: temporary, at-home treatments such as nasal strips and sprays or full-fledged surgery. Vivaer, Aerin Medical's nasal airway modeling device, bridges the gap between the current options by offering a permanent solution without invasive surgery. After applying a local anesthetic, a doctor applies a wand to the area inside the nose where the cartilage meets the septum, opening and smoothing the structure with low-temperature radio frequency. A minor change in the structure results in a major improvement in airflow, with early test data showing results on par with surgery, according to Aerin Medical. Vivaer is undergoing clinical trials at Ohio State University.

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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 September 30, 2018, BJ's Wholesale Club Holdings Inc., Harris Corp., Limelight Networks Inc., and RingCentral Inc. represented 0.30, 1.61, 1.06 and 1.62 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Harris at 2.12 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held BJ's, Harris and RingCentral at 1.93, 2.06 and 2.09 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. Gross Domestic Product, or GDP, is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. Friess Associates LLC serves as the subadvisor to certain mutual funds advised by AMG Funds.

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