Looking Forward

Friess Associates market observations and insights

March 31, 2019

Earnings, Not Buybacks, Determine Whether a Company is a Good Buy

CNBC noted that "Buyback fuel for the bull market is losing steam" roughly three years ago on March 28, 2016. It was a proclamation supported by the facts of the day and by trends that later became evident as the first quarter of that year proved to be the high point for buybacks for the rest of 2016 and all of 2017.

Then came 2018, a year marked by four consecutive quarterly all-time highs for aggregate share repurchases among the companies that make up the S&P 500 Index. The fourth quarter, in which the index's companies bought back $223 billion worth of shares, was up 68 percent from the same period in the prior year. In all, these companies dedicated more than $800 billion to buybacks last year, according to S&P Dow Jones Indices.

The theory is that stock buybacks, by boosting earnings per share among companies that execute them, can lift share prices as the pool of outstanding shares shrinks. Considering last year's nosebleed levels and the since-passed anniversary of the tax cuts that helped juice their rise, predicting an impending loss of buyback steam seems like a reasonable prognostication once again. So, trouble lurks, right?

Not exactly. We make investment decisions one company at a time, and whether or not a company is currently buying back shares is never a determining factor. A share repurchase plan is typically a positive item in a pro-versus-con analysis, but it generally ranks low on the list of affirmative attributes. We want to hold companies that generate organic growth.

Moreover, the additional source of broader demand that buybacks represent hardly seems in jeopardy. Nobody is predicting corporate share repurchases are poised to dry up. For example, Bank of America Merrill Lynch, which executes share repurchases for its publicly traded corporate clients, said in a February report that buybacks are "on pace for another record year" in 2019.

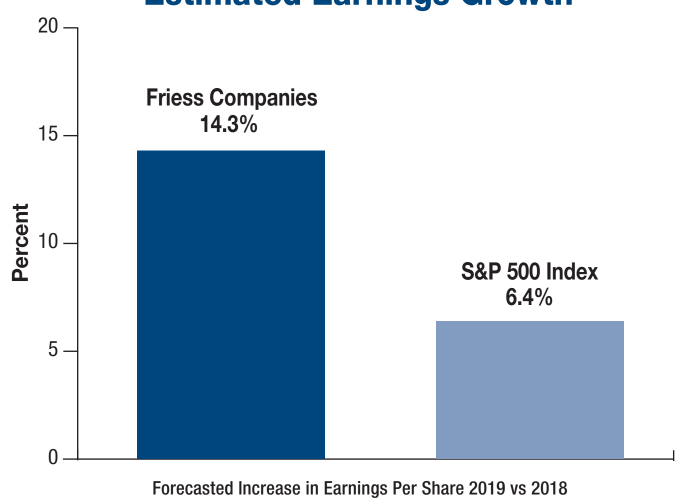
Some market watchers believe that, in itself, is a bad thing. They argue that heated buyback activity is symptomatic of a growing issue, one that ultimately threatens the outlook.

Buying back shares means forgoing business investments and/or acquisitions, the thinking goes. In fact, 2018 was the first year since 2007 in which companies dedicated more capital to share repurchases than capital expenditures.

Still, last year's capital expenditures among companies in the S&P 500 Index broke the record set in 2014. The corporate tax cut boosted buyback efforts, likely leaving many companies with bigger one-time windfalls than expansion-minded projects to fund with them in the near-term. Even with last year's buyback surge, capital expenditures outpaced buybacks by 18 percent each year on average over the trailing 10 years, according to Citigroup.

We train our focus on the earnings landscape, which to start off 2019 looks rockier than recent years past. Based on the consensus estimate, Wall Street predicts that first-quarter earnings for the companies in the S&P 500 will contract, representing the index's first year-over-year earnings decline since the second quarter of 2016.

Estimated Earnings Growth



Source: Consensus estimates from FactSet Research Systems Inc., as of March 31, 2019.

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.

After starting the period with expectations for 2.9 percent first-quarter growth, analysts revised their estimates downward by the end of the three months through March to forecast a 3.9 percent decline, according to FactSet Research Systems. Their earnings outlook improves from there, with predictions for single-digit growth rising incrementally from one quarter to the next as the year progresses.

On the surface, expectations for modest earnings growth stand in contrast to last year's 20-plus-percent advance. That number, however, benefited from favorable year-over-year comparisons made possible by the notably lower corporate tax rate in 2018 versus 2017. Given the economic backdrop and pressure related to tight labor supply and trade tension, reserved earnings expectations seem reasonably in line with current conditions.

One key advantage to being a stock picker is not having to settle for companies executing in a fashion that is typical for a given point in time. Why shop for average when there's plenty of above-average to be found?

Analysts predict the companies of the S&P 500 Index will grow earnings 6.4 percent in 2019, on average. Based on consensus estimates, the average company held in Friess-managed portfolios is expected to grow earnings 14.3 percent this year, or more than twice the rate of the index. Since we aim to isolate companies that exceed expectations, the predicted Friess portfolio growth rate would be higher using our internal forecasts.

After growing earnings by one-third in 2018, the folks at Vulcan Materials Co. (page 5) are confident in their ability to keep it going for the right reasons: the company's ability to execute and a persistent need for its products. In February, Vulcan's chief executive said, "We expect double-digit earnings growth again in 2019, given the strength of our operational performance and continuing growth in public sector demand."

Vulcan is the nation's largest producer of construction aggregates (crushed stone, sand and gravel) and a major producer of construction materials made from aggregates. Nearly anyone who's driven on a major highway in recent months can vouch for the need for improvement. As state and federal funds converge to upgrade the nation's ailing infrastructure, Vulcan's recent results detail trends in shipments, pricing and profitability working in the company's favor.

The average age of the light vehicles traversing U.S. roadways continues to march higher, nearing 12 years at last count, according to the Bureau of Transportation Statistics. Add registered vehicle and miles driven tallies at or near records and the result is ample demand for maintenance and repair work. With a growing population of older cars driving an increasing number of miles, conditions in the auto parts business are healthy. We believe O'Reilly Auto Parts (page 4) is uniquely positioned to make the most of the situation.

The company's commitment to customer service and parts availability earns its stores consistent draw: Last year O'Reilly's enjoyed its twenty-sixth consecutive annual increase in same-store sales. As for profitability, 2018 was the 10 year in a row for diluted earnings per share growth of 15 percent or more. Generating nearly half its sales via proprietary brands, we expect the company's profit performance to remain strong.

When it comes to performance, few forms of entertainment ignite passion among its fans like the content created by World Wrestling Entertainment, or WWE (page 5). The casual observer might assume professional wrestling is a niche, domestic interest, but wrestling fans know better. WWE, which broadcast last year's Royal Rumble from Jeddah, Saudi Arabia, continues to successfully export its long-running version of a sporting soap opera overseas.

International markets generated more than one-third of WWE's $930 million in 2018 revenue. After more than tripling previous fees in recent U.S. television contract renewals, the company is set to renew agreements in the United Kingdom and India, its second and third largest markets, respectively.

With $1.2 billion in 2018 revenue, Horizon Pharma (page 4) is a biopharmaceutical company focused on treatments for rare diseases. Horizon's biggest drug, Krystexxa, is the last available line of treatment for gout that doesn't respond to other existing treatments. Krystexxa sales increased 90 percent in the three months through September, bringing growth for the full year to 65 percent. Horizon estimates the drug's annual revenue could eventually triple to more than $750 million.

Additional excitement surrounds the company's pipeline, where phase III clinical trial results could help make Horizon's teprotumumab compound, if approved, a breakthrough as the first therapy to treat thyroid eye disease. The company believes that tepro promises similar commercial potential to Krystexxa.

Thanks for your continued confidence. Best wishes from your entire Friess team.

Scott

Scott Gates
Chief Investment Officer

Interest Rates Boast Broad Reach

Early this year the U.S. Federal Reserve Bank (the "Fed") signaled that its campaign to raise interest rates would be on hold for now. The Fed's apparent change of heart came abruptly following four rate increases last year and what it described as a turn in data related to both domestic and overseas economic growth. While debate around the correct monetary policy remains lively, investors can be certain that the general outlook isn't as clear as it seemed a short time ago.

The Fed's mandate is to promote maximum employment, stable prices and moderate long-term interest rates. The central bank regularly influences interest rates in pursuit of its policy goals, an exercise that requires finesse to strike the intended consequences.

Lowering rates is expansionary in that it encourages lending and spending by consumers and businesses, but it can also contribute to inflation and asset bubbles. Increasing rates is contractionary by discouraging lending and spending, with the risk being its potential to weigh on the economy and asset values. Interest rates tend to rise late in the business cycle, when unemployment is low, the economy is firing on all cylinders and corporate profits are high.

The recent inversion in the yield curve (where short-term treasury yields are higher than longer-term rates farther out on the curve) brought with it headlines about the phenomenon's track record in presaging an impending recession. While we don't try to predict the timing of market cycles, the inversion reflects rising short-term rates amid persistently tame expectations about future inflation.

Bond markets, represented by higher short term rates, and stock investors, represented by lower demand at the long end of the curve, are currently drawing different conclusions. Figuring out which side is right typically doesn't take long to materialize. Either way, our research process is focused on making sure we understand how current and future rates might affect the earnings landscape.

Changes in monetary policy immediately impact interest rates for borrowing, touching everything from consumer mortgage and auto loans to interest payments and pension discount rates on corporate balance sheets. What may not be so apparent in the headlines are the wide-ranging effects that a changing monetary policy can eventually have on individual-company fundamentals.

For example, we spoke to an operator of buy here/pay here used-car dealerships that lends at higher rates to offset higher credit risk among its customers. The company saw an increase in business as interest rates move up from low levels. Higher interest rates raised the cost of funds for competitive offerings, increasing demand by making the company's financing options more competitive in the market. At the current rate level, credit metrics, including loss rates and delinquencies, also trended down substantially.

Companies involved in homebuilding are especially sensitive to interest rate concerns. Not surprisingly, homebuilders performed well early this year as the rate environment grew more dovish. That said, the jury is still out as order growth remains negative year-over-year and likely won't inflect until summer in most cases.

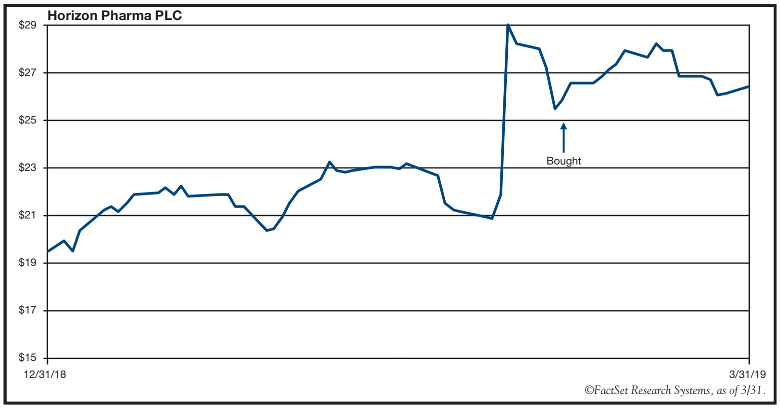
The impact on homebuilders reverberates through adjacent companies in the industrial and materials sectors that see their fortunes influenced by trends in residential and commercial construction. In some cases, higher demand for building materials, construction equipment and aggregates are now being accompanied by low inventory levels and price increases at companies exposed to these trends.

Energy companies are also notoriously interest-rate sensitive. There is a high fixed cost to extracting hydrocarbons from inside the earth, so balance sheet strength and changing metrics often point toward future growth opportunities or challenges.

Additionally, there is a historical inverse relationship between commodity prices and interest rates. The reason that interest rates and raw material prices are so closely correlated is the cost of holding inventory. When interest rates move higher, the prices of commodities tend to move lower. When rates move lower, commodities tend to rise.

Our company-by-company approach is focused on finding companies best able to transform fundamental improvements into future earnings growth. Understanding the impact interest rates have today and in the future plays an important role in our research process. As sentiment around the timing and pace of future rate decisions changes, we continue to expect that well-managed companies with solid fundamentals will navigate the conditions best.

Horizon Pharma plc, HZNP



While there is no cure for more than 8 million Americans with a painful and potentially debilitating joint condition called gout, treatments are evolving. Horizon Pharma is at the forefront of the newest medications on the market, helping patients manage gout symptoms that up until recently could not be controlled by other means.

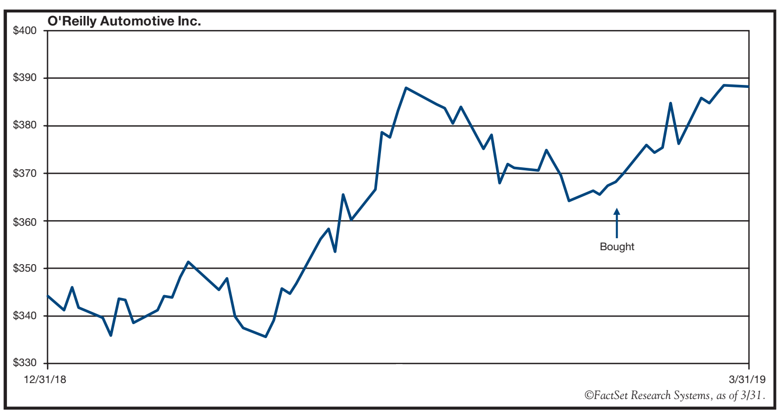
Nasdaq-listed Horizon Pharma plc is a biopharmaceutical company focused on treatments for unmet, often rare, medical needs. The company markets 11 medicines through its orphan, rheumatology and primary care business units. Sales grew 14 percent to $1.2 billion in 2018.

December-quarter sales increased 30 percent, driven in large part by a 33 percent rise in the company's orphan and rheumatology segment. Sales of Horizon's Krystexxa drug used to treat chronic grout continued to show strong demand trends, with growth of 90 percent in the quarter and 65 percent for the year. Krystexxa continues to present opportunities for indication expansion, including plans to initiate a study in kidney transplant patients, a group with a prevalence of gout 10 times higher than the general population.

Your team spoke with Chief Executive Timothy Walbert about future growth opportunities as the company readied to complete a secondary offering. In late February, Horizon announced positive results from a phase III confirmatory trial evaluating its medication teprotumumab for the treatment of active thyroid eye disease. The Food and Drug Administration designates Teprotumumab as a breakthrough therapy, orphan drug and fast track candidate.

Horizon used the proceeds from the equity offering to pay down debt, strengthening its balance sheet. It also added $200 million to existing revolving loan capacity, potentially ahead of increased working capital needs associated with continued growth in its rare disease franchises.

O'Reilly Auto Parts Inc., ORLY



With the average age of the U.S. light vehicle population pushing 12 years, drivers must be doing something to avoid pushing their well-worn wheels past the point of road worthiness. As the growing size and age of the domestic vehicle population drive demand for maintenance and repair work, O'Reilly Auto Parts positions itself to enjoy the ride.

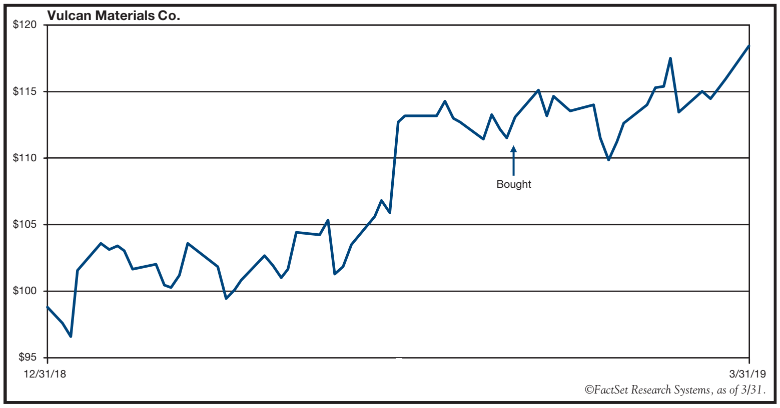
Nasdaq-listed O'Reilly Auto Parts Inc. is the nation's third largest retailer of aftermarket auto parts and related supplies based on store count. The company operates 5,219 stores in 47 states, serving both the do-it-yourself and professional service provider markets. Revenue climbed to more than $9.5 billion in 2018.

In a market served by a robust collection of big chains and mom-and-pop operations, customers have plenty of choices. O'Reilly strives to keep itself among the top considerations whenever an auto part need arises by executing a strategy that emphasizes consistently satisfying customers through superior service and extensive inventory. The results: O'Reilly marked its 26 consecutive year of same-store sales growth last year on its way to generating record revenue.

A commitment to cost control and careful attention paid to product mix help O'Reilly profit from its sales progress. The company grew December-quarter earnings 35 percent, capping off a year in which operating income reached an all-time high. It was also the tenth straight year in which O'Reilly grew diluted earnings per share by at least 15 percent.

While broader trends boost the auto parts business in general, we believe O'Reilly is unique in its ability to make the most of them. Thanks to an extensive national distribution network, exhaustive in-store inventory and five-day-a-week store restocking, O'Reilly claims industry leading parts availability. Nearly half of the sales the company generates come from proprietary brands, contributing to profitability.

Vulcan Materials Co., VMC



A recent report on California's transportation infrastructure found nearly half of the state's roads in poor condition. The Golden State also boasts 13 of the nation's top 25 most traveled structurally deficient bridges. While state and national funding has been allocated for years, project-level spending on Vulcan's basic aggregates is just now gaining speed.

Nasdaq-listed Vulcan Materials Co. is the nation's largest producer of construction aggregates, including crushed stone, sand and gravel. The company is also a major producer of aggregates-based construction materials such as asphalt and ready-mixed concrete. Operating primarily in the eastern U.S., Vulcan does significant business in California, Florida, Texas and, increasingly, the Midwest. Revenue grew 13 percent to $4.4 billion last year.

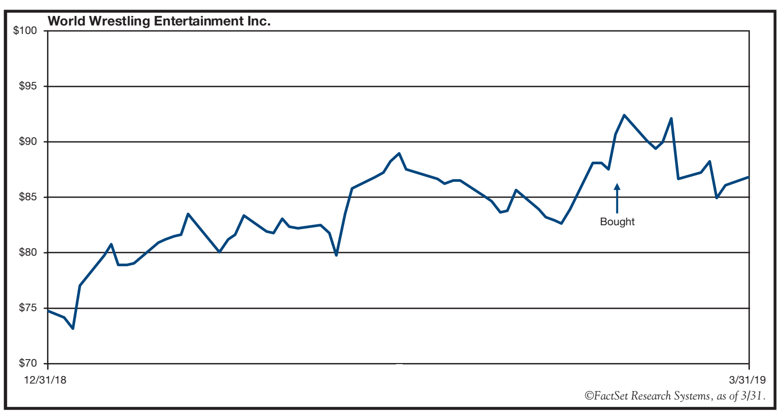
December-quarter earnings grew 34 percent, beating the consensus estimate by 12 percent. Sales rose 11 percent as activity stemming from previously announced infrastructure projects picked up, leading to shipment growth and pricing improvements for aggregates. During the quarter, Vulcan mitigated a 17 percent increase in diesel fuel costs through operational improvements. The company reported full-year incremental gross profits on aggregates of 64 percent.

A combination of increased state-level funding and spending related to the Fixing America's Surface Infrastructure Act, which in December 2015 authorized $305 billion in federal funds for use from 2016 to 2020, helps fuel demand.

Following the company's earnings report, management forecasted continued growth in 2019 driven by public sector demand and aggregates pricing momentum in large growth markets. Given the company's considerable base of fixed assets, operating profit margins are highly leveraged to increasing volume and pricing.

Based on the consensus estimate, Wall Street expects Vulcan to grow earnings 19 percent in 2019.

World Wrestling Entertainment Inc., WWE



After uniting disparate pockets of regional wrestling, World Wrestling Entertainment built itself into the premier professional wrestling organization in the United States. Now, with events and television contracts overseas helping drive 58 percent growth in international markets over the past year, the company boasts expansion ambitions more befitting its name.

NYSE-listed World Wrestling Entertainment, or WWE, is the largest professional wrestling company in the world. Tracing its roots to the Northeast in the 1950s, the Stamford, Conn.-based company today maintains offices in New York, Los Angeles, London, Mexico City, Mumbai, Shanghai, Singapore, Dubai, Munich and Tokyo. Revenue grew 16 percent to $930 million in the 12 months through December, with international markets generating just over one-third of the total.

WWE earned $0.46 per share in the three months through December, up from $0.20 in the year-ago period and 67 percent ahead of the consensus estimate. The company's media division, consisting of television contracts, content rights and advertising, drove a 29 percent revenue increase.

Responsible for about three-quarters of revenue, the media division is WWE's largest business unit. (Live events and consumer products account for the rest.) The company's television contracts in the United Kingdom and India, WWE's second and third largest markets, respectively, are up for renewal this year, offering potential for notable growth following successful negotiations in the U.S. market. U.S. television fees were renewed at 3.6 times their previous level.

Other potential intermediate-term growth drivers include additional television deals (China, Latin America and the Middle East), an updated strategy for the WWE Network, additional programming related to its Smackdown franchise and greater sponsorship negotiating leverage.

Recognizing Risk is Part of the Process

Stock investing is a risky business. No matter what investment strategy a manager employs, decisions stemming from it are plays on probability. Even the most informed, well-founded decisions don't guarantee any particular outcome. That's why it's important to make risk control an integral part of the investment process.

We view risk as any threat to our intended investment outcome and, as a result, strive to minimize it from various angles through our investment strategy and portfolio management practices. As bottom-up investors, we believe company-specific risk is the biggest threat to a successful investment.

Negative business outcomes invite share-price declines. We aim to reduce company-specific risk by focusing on companies that demonstrate operational strength and, based on our research, appear poised for repeat performance. We also stress companies with fortunes linked to their ability to execute over companies that are highly dependent on commodity prices and other unpredictable macro factors.

Valuation risk is another factor that we address one company at a time. We tend to be more conservative than many growth managers in that we purchase companies at what we believe to be reasonable multiples of forward earnings estimates in order to minimize downside risk. Our price targets also reflect our conservative approach to valuations.

Our process is also designed to encourage us to always put the money entrusted to us to what our research indicates to be its best use. Consistent with our approach to company-specific risk, we move to control investment risk by admitting when we're wrong. When a company we hold disappoints, our process prompts us to reduce opportunity cost by switching from the existing holding to a new opportunity with better upside potential.

Although we construct the portfolio one company at a time, we often identify pockets of earnings strength concentrated in certain sectors. We remain alert to cross-sector risk and concentrations within sectors and industries as we assess each new opportunity. We capitalize on the variety within sectors and promote diversification by limiting industry representation to 15 percent of assets.

We also consider liquidity risk when we build positions in individual securities. The idea is to maintain the flexibility to execute whatever investment decision we need to make on our terms. By limiting initial position sizes and capping their window to grow, we contribute to our ability to trade stocks at our research team's direction without impacting pricing or telegraphing our intentions.

Our team of analysts monitors company-specific risk through continuous research. At the same time, using security analysis software and internal reports generated on a daily basis, our chief investment officer monitors portfolio characteristics to ensure that the collection of holdings that our team follows and the current group of target companies reflect our broadly stated risk parameters.

Reflecting our company-by-company approach, our strategy performs best in normal market conditions in which investors judge each company on its own merits. It can underperform in macro-driven environments in which investors view broad factors, such as heightened economic uncertainty or geopolitical developments, as either good or bad for stocks as a group. Since we seek to identify stocks that outperform for company-specific reasons, the elevated correlation among stock prices that tends to occur in macro markets temporarily limits the effectiveness of stock picking.

Our commitment to an individual-company approach is evident in our portfolio construction process. The makeup of the portfolio comes together one company at a time without regard to the composition of benchmark indexes. Aside from the aforementioned risk-related limits, portfolio characteristics such as sector weightings are byproducts of our bottom-up search for companies with above-average earnings growth potential. In the end, our goal is to outperform the indexes, not mimic them.

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.

Get in the Booth and Call the Doctor

From drugstore walk-in clinics to strip-mall urgent care centers, medical practitioners find themselves far afield from traditional office and hospital settings as convenience becomes a greater consideration in the delivery of health care. OnMed seeks to further the trend toward convenience without furthering the need to relocate medical professionals in the process. The OnMed Station, as the Clearwater, Fla.-based company calls it, is a booth outfitted with the latest in biometric, audio, video and sensor technology to facilitate cutting edge telemedicine. Remotely linking patient and doctor, their discussion is accompanied by real-time vital sign tracking, thermal imaging and HD cameras that enable close-up inspection of everything from a sore throat to a skin lesion. Post-visit, the station can dispense a broad array of common drugs or print a prescription to be filled elsewhere. The stations sanitize the booth's air and surfaces between patients with the assistance of ultraviolet technology. OnMed plans to begin deploying its first units this year, targeting airports, colleges, hotels and large employers as initial sites.

Fingerprints Promise to Pay

The squiggled line that passes for your signature on the device that reads your credit card at the checkout counter is, not surprisingly, something less than a foolproof security measure. Credit card companies know that better than anyone else and, as a result, they've spent years pursuing a more effective way to ensure that the rightful cardholder is the person holding the card at the point of sale. Now, with successful pilot programs in their recent past, credit card payment networks are poised to integrate biometric identification into on-site credit card purchases. Visa last year began testing cards in a real-world setting using chip technology combined with fingerprint identification facilitated by print-reading sensors on the cards. The pilot, conducted among cardholders at Mountain America Credit Union and Bank of Cyprus, concluded late last year. Cardholders store their prints to their cards, which only approve a transaction when the stored print is matched. Mastercard, which ran trials in South Africa and Bulgaria, is aiming to offer biometric payment cards across Europe this spring.

Custom-Printed Skin

Researchers in recent years recognized the potential for 3D printers to produce human skin to aid in wound healing. Using a patient's own skin cells, prototype devices generated sheets of material to size and apply as grafts over injuries. Researchers at Wake Forest Institute for Regenerative Medicine developed a more refined process that promises to achieve better outcomes in less time. The printer's "ink" consists of hydrogel mixed with two types of cells isolated from a patient: fibroblasts, which help build wound healing structure, and keratinocytes, which are the main cells in the outermost layer of skin. Unlike previous wound-related bioprinting efforts, the Wake Forest team first maps the topography of a wound using a 3D laser scanner. Operating directly overtop, the printer applies fibroblasts to the deepest parts of the wound. It then applies layers of keratinocytes to finish the job. Experiments in mice yielded quick and successful results. Successful clinical trials could lead to applications in treating burns, diabetic ulcers and other difficult-to-heal wounds.

Tail's Underbelly Tells a Tale of Potential

From the cat's tongue and the gecko's grip to lizard saliva and spider silk, turning to the animal kingdom for inspiration in solving human problems, or "biomimicry," drives an ever-expanding field of scientific discovery. The lobster tail is among the latest natural targets for study on the research menu, but probably not for the reason a typical seafood lover might think. Even one of the primary applications under consideration, body armor, might prove misleading in that the crustacean's protective shell isn't of particular interest. Researchers at MIT believe unique properties make the translucent membrane visible on the lobster tail's underside worthy of in-depth study. The membrane is a hydrogel consisting of 90 percent water and 10 percent chitin, the fibrous material found in shells and exoskeletons. MIT discovered that the membrane is the world's strongest known hydrogel. Unlike other hydrogels, the membrane becomes tougher as it is stretched, and it maintains its integrity even when cut halfway through its thickness. Researchers hope their work leads to more flexible body armor, with additional applications possible in soft robotics and tissue engineering.

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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, 2019, Horizon Pharma plc, O'Reilly Auto Parts Inc., Vulcan Materials Co. and World Wrestling Entertainment Inc. represented 0.74, 1.57, 1.13 and 1.41 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held O'Reilly Auto Parts and Vulcan Materials at 2.08 and 2.08 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held Horizon, O'Reilly Auto Parts, World Wrestling Entertainment and Vulcan Materials at 2.06, 2.37, 2.37 and 2.12 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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