Looking Forward

Friess Associates market observations and insights

December 31, 2020

Stocks Did What Now?

Allow us to set the scene. An until-then unknown and dangerous virus spreads around the world in a matter of months. Infections and deaths mount as the pandemic becomes a fact of life for the better part of the calendar year. The global economy sputters amid a patchwork of restrictive measures meant to thwart the disease's advance, resulting in mass joblessness.

Disrupted commerce. Strained transnational relationships. Political disarray atop the world's largest economy. The reasons for despair seemed to outnumber fingers on which to count them in 2020, yet Wall Street, after a brief period of shock, propelled major market indexes to record highs. The history of this market will read like fiction to future generations.

It will also reinforce the lesson that we learned early on as a firm. The best educated guess about the stock market is still just a guess. "Never invest in the stock market" is the opening line of our firm's guiding motto because "the market" is the collective result of an ever-changing and unpredictable conglomeration of incalculable variables.

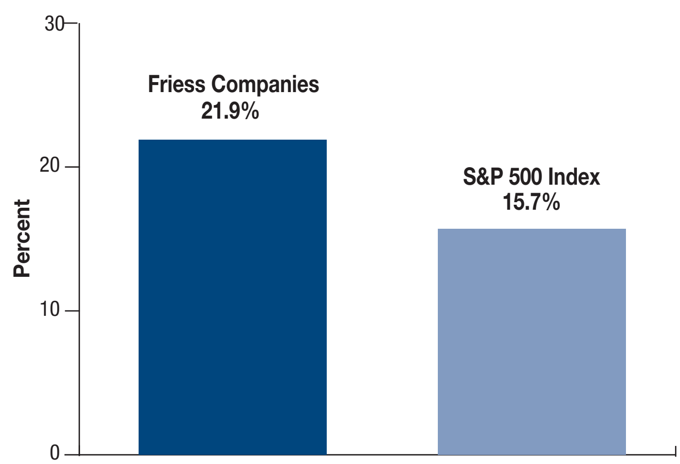
The affirmative conclusion to our motto, "invest in individual businesses," is what we draw on for direction and clarity even when the broader market falls short in that regard. Companies are judged by their ability to make money for their shareholders. To us, it makes sense to consistently focus on companies best positioned to grow profits no matter what the market watchers predict because we believe earnings performance is the ultimate influence on stock prices.

Do we think the rally will continue, or is the recent run too much too soon? Like anyone else in this business, we have opinions. But they don't matter in the grand scheme of things. Given our philosophy, the answer as to whether stocks continue to climb in 2021 or pay a price for the enthusiasm on display in 2020 comes down to one key factor: earnings.

Few would argue that one development that investors celebrated in 2020, the successful deployment of messenger RNA, or mRNA, in a vaccine is anything but a bona fide breakthrough. Hopes are high that new vaccines using mRNA as their delivery system to prevent other viruses, including current clinical trials for influenza, rabies and Zika vaccines, will soon follow. Drug developers believe mRNA medicines show promise well beyond vaccines.

The reported effectiveness of the mRNA vaccines gave investors real-time reason for optimism regarding the technology and companies with ties to it. In other instances, however, investor enthusiasm stemmed from upbeat assumptions about fiscal stimulus, economic resilience and the duration of the pandemic, among other important matters. We will soon learn whether these assumptions prove to be well-founded or just well-intended.

Estimated Earnings Growth



Forecasted Increase in Earnings Per Share 2021 vs 2020

Source: Consensus estimates from FactSet Research Systems Inc., as of December 31, 2020.

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.

However it turns out, we're not making broad bets on the potential outcomes. We expect 2021 to be a good year because we continue to find companies with strong earnings growth prospects and solid potential to exceed consensus earnings expectations. That's not a performance prediction. We say "good" because we believe finding companies that meet our earnings growth criteria puts us in the best position to grow the assets entrusted to us.

Although our compliance officer tends to use a red pen on promissory statements, we feel confident in guaranteeing that other investors won't always agree with us as the year plays out. (Our compliance officer made us add the part about feeling confident to what was originally more of a no-nonsense guarantee.) There will be times when their decision-making is motivated by something other than earnings.

Still, a consistent focus on individual-company earnings trends is key. The insights that we gather on an ongoing basis often reveal opportunities and risks evident on the frontlines of the economy before they're aggregated and summarized in some market-moving report issued by the government.

The fourth-quarter earnings results being released by the time this report reaches you will represent the last year-over-year comparisons that compare business amid pandemic conditions against a full three-month period that was pre-pandemic. It appears strong growth lies ahead when quarters in 2021 mark their anniversaries versus the tough conditions of 2020.

Companies held in the portfolios we manage are expected to grow earnings 21.9 percent on average in 2021, according to consensus earnings estimates compiled by FactSet Research Systems. The companies that make up the S&P 500 Index are expected to grow earnings 15.7 percent on average in the same period.

Commvault Systems (page 4) is expected to finish its fiscal year ending in March with 30 percent earnings growth. On top of secular trends driving demand to store and best utilize data, the spike in remote connections driven by the pandemic introduces a new level of security risk to companies and their data. The confluence of data management needs contributes to demand for Commvault's data readiness software for storing, protecting and optimizing data.

Visibility into Commvault's business continued to improve in its most recently reported quarter as the ongoing nature of data management needs contributed to a 9 percent increase in recurring revenue. Annualized recurring revenue at the end of September represented 71 percent of total revenue for the 12 months through September.

Known for athletic apparel, Lululemon Athletica (page 4) at the end of June acquired Mirror, adding a recurring revenue component to the company's future growth potential. Vogue called Mirror "The wellness industry's most game-changing device yet." The New York Times described it as "The future of personalized remote exercise." We think Lululemon's decision to integrate Mirror into its model represents one of the smartest strategic moves in recent memory.

Mirror is a sleek, wall-mounted display sells that for $1,495, with users paying $39 a month for content. In addition to representing a new opportunity for scalable, recurring revenue, it puts Lululemon, its brand ambassadors and its products in the homes of Mirror users through the content it delivers.

Builders FirstSource (page 4) in August announced it would merge with competitor BMC Stock Holdings, strengthening Builders FirstSource's leadership position in the fragmented market for building materials used in residential construction.

With borrowing costs hovering at historic lows and existing home supply tight, the timing appears good for a combined entity with expanded product offerings and geographical reach. Builders FirstSource now boasts about 550 manufacturing and distribution locations spanning 40 states, including 44 of the top 50 metropolitan statistical areas.

PayPal Holdings (page 5) is the largest digital platform for money transfer services. While anyone who's made an online purchase knows PayPal as a prominent option for executing the transaction, anyone who's been watching the company in recent years knows that PayPal is striving to become much more.

PayPal's various business units position it to achieve its goal of becoming "the most compelling and expansive digital wallet," with its technology playing an end-to-end role in purchase processes from research and digital coupon clipping to payment. The company is also expanding payment options, including "Buy Now Pay Later" installment plans, the Venmo Credit Card and cryptocurrency.

As 2021 gets underway, topics of interest include reflation (page 3) and the risk control measures we incorporate into our investment strategy (page 6). We're encouraged by the individual-company earnings trends we're uncovering on your behalf. Thanks for your long-term focus and continued confidence.

Scott

Scott Gates
Chief Investment Officer

The Broad Force of Reflation and Its Many Implications

Investopedia defines reflation as "a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. The term may also be used to describe the first phase of economic recovery after a period of contraction." An economically disruptive global pandemic followed by a historic monetary response seems like a case in point.

In simpler terms, the goal of reflation is to return a weakened economy back toward normal, healthy levels of growth and inflation. Following the Great Recession, for example, the U.S. Federal Reserve Bank quickly moved short-term rates to zero and later injected additional liquidity into the system through a campaign of quantitative easing. Epic stimulus spending, rock-bottom rates and warp-speed vaccine development all point toward reignited growth.

It's not easy to determine when and how this impacts individual companies and specific sectors of the economy. Reflation is typically characterized by both a bump in the prices of goods and a rise in wages with which to pay for them. It certainly doesn't create an even playing field for all participants.

The Bureau of Labor Statistics reported that consumer prices rose at an annual rate of only 1.2 percent in November. The weakness due mostly to energy prices, which remain down from year-ago levels amid weaker demand. Meanwhile, prices for copper and other industrial metals are already soaring, boosting sales for some and raising costs for others.

While copper has been used in vehicles for decades, electric vehicles use three times more copper than traditional automobiles. Further, being a highly efficient conductor of electricity and heat, copper is the most used metal in renewable energy systems for power generation from solar, hydro, thermal and wind energy globally. A wind power generator uses 2.5 to 6 tons of copper per megawatt. It is estimated that around 200 three-megawatt wind turbines are needed to replace just one large steam coal or gas turbine.

The housing market mounted a pronounced "V" shaped recovery after essentially coming to a standstill. The main reasons are related to factors existing before the pandemic hit, including limited home supply, historically low mortgage rates and millennial demand for homeownership. Basic supply-and-demand economics are driving growth in home prices at the fastest pace since 2004 to all-time highs.

Lumber mills initially curtailed production when the pandemic hit on the assumption that housing demand would be depressed. While initially correct, consumers responded to stay-at-home and social-distancing mandates by making home improvements and, eventually, looking for new homes. Lumber prices increased 275 percent in the six months through December, adding considerable costs to everything from a dining room chair to a new house.

Agriculture markets also went on the roller coaster ride in 2020, starting with a violent drop in demand related to the pandemic and recovering by the end of the year.

Soybean and corn prices ended 2020 at six-and-a-half year highs. Behind the moves were the first major supply disruptions in years, driving double-digit price gains. Dry weather globally and troubles with exports in South America reduced yields and expectations for what were forecast to be bumper crops. At the same time, Chinese demand surged as the nation sought to rebuild hog herds following an outbreak of Asian swine fever in 2019.

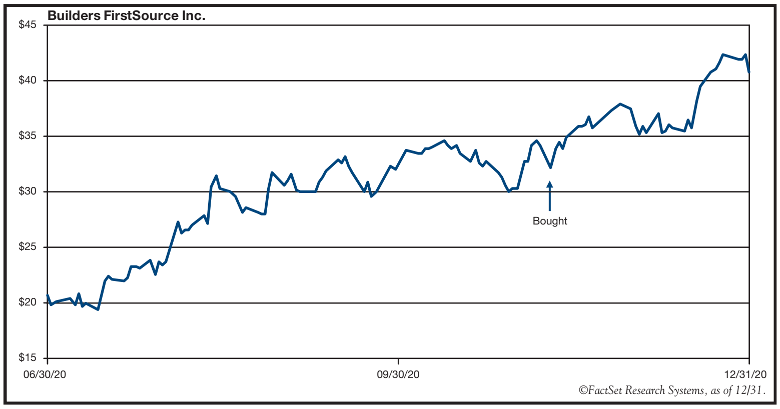
A drop in the dollar's value relative to other major currencies to its weakest since April 2018 also boosted export prospects for U.S. grain.

In November, the Agriculture Department said it expects U.S. inventories of wheat and corn to end their current marketing years (most recent one-year reporting period, not necessarily corresponding with the calendar year) 15 percent lower than in the prior ones. The implications range from higher farm incomes and spending on tractors and fertilizers to higher food costs at a time when millions remain unemployed.

Nearly 800,000 Americans filed for unemployment benefits in the week before Christmas, the last snapshot of the 2019 job market. Unemployment claims have been rising again in recent weeks as a resurgence in coronavirus rates slowed hiring and spurred layoffs. At current levels, the weekly figures are about four times their pre-pandemic average. It is hard to see overall inflation moving much higher until jobs and wages support it.

The efforts made to revive struggling economies around the world will no doubt play a role in what lies ahead. While the consensus is that reflation continues, we realize it only matters if we are invested in the companies most able to benefit from it.

Builders FirstSource Inc., BLDR



Builders FirstSource announced in August it would merge with rival BMC Stock Holdings. With estimated annual sales topping $11 billion and team members numbering about 26,000, the combination will create a giant supplier of building materials and services in what remains a fragmented industry.

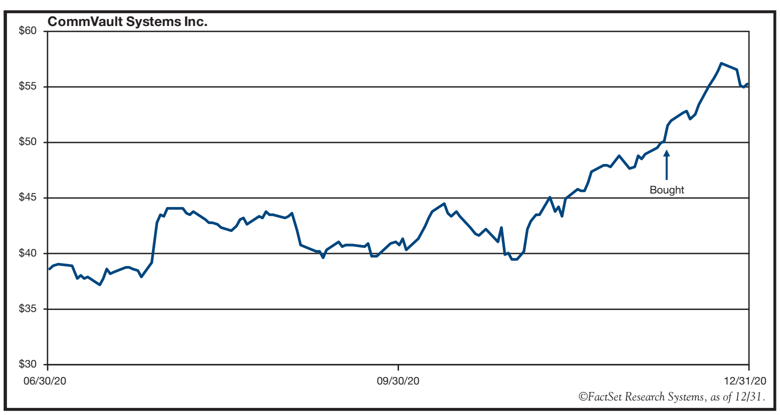
Even prior to the announcement, Nasdaq-listed Builders FirstSource Inc. was already the nation's largest publicly traded supplier of structural building products, value-added components and services to the professional markets for homebuilding and remodeling. Revenue reached $7.8 billion in the 12 months through September.

September-quarter sales rose 16 percent to $2.3 billion as demand for new residential homes recovered quickly after falling off at the start of the pandemic. Historically low borrowing costs and low supply of existing homes contributed to strong home sales. Earnings grew 22 percent, beating the consensus estimate by 27 percent. The company reined in selling, general and administrative costs, which helped offset gross profit margin pressure from volatile lumber costs and helped enable the solid bottom-line results.

As Builders FirstSource integrates BMC, the company should benefit from greater geographic reach and diversity. The Builders FirstSource network will expand to roughly 550 distribution and manufacturing locations in 40 states, including 44 of the top 50 metropolitan statistical areas. BMC's millwork capability and ready-frame pre-built framing offerings will likely complement Builders FirstSource's strengths in trusses and manufactured components.

Management estimates annual cost synergies of between $130 million and $150 million by year three of the deal. Filling in product gaps in geographies across the U.S. could provide additional sales-growth opportunities.

Commvault Systems Inc., CVLT



The number of targeted attacks on critical data increased dramatically in 2020 as the security landscape expanded with growth in remote access. Commvault received the highest scores across Public Cloud, Virtual and Physical Server environments in this year's Gartner Critical Capabilities for Backup and Recovery.

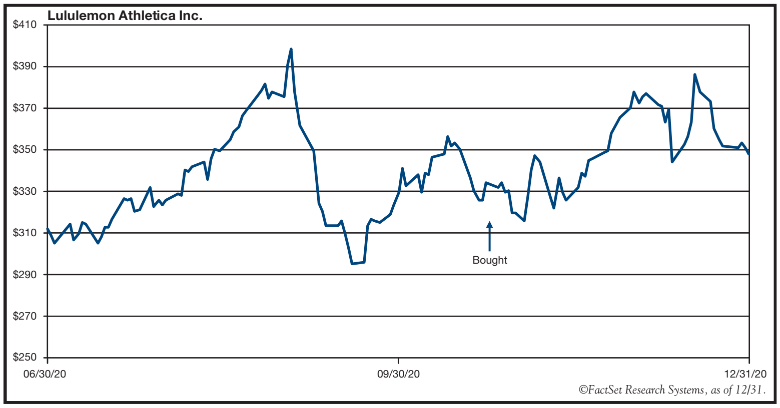
Nasdaq-listed Commvault Systems Inc. is a recognized leader in delivering data readiness, enabling customers to intelligently store, protect and optimize data. The company's software automates tasks and makes data work harder for customers so they can gain valuable insights for their businesses. Commvault solutions work across cloud and on-premises environments. Revenue grew to $682 million in the 12 months through September.

September-quarter earnings topped the consensus estimate by 32 percent, as subscriptions for the company's new software products contributed a greater amount to overall revenue. Annualized recurring revenue, which is the annualized value of all active Commvault recurring revenue streams, was $484 million at the end of the quarter, up 9 percent from the year before.

Chief Executive Sanjay Mirchandani, who joined the company in April, spoke to your team about focusing on new products that represent a series of first-mover advantages, addressing critical needs like cloud transformation, and thwarting complex attacks aimed at encrypting data and holding it hostage.

Metallic, Commvault's newest enterprise-grade cloud-based data protection program, allows customers to secure data wherever it resides while still maintaining a local copy that can be restored almost immediately. The company recently noted that Metallic now protects tens of thousands of Office 365 mailboxes and 5 petabytes of endpoint data. Based on the consensus estimate, Wall Street expects the company to finish its fiscal year ending March 2021 with 30 percent earnings growth.

Lululemon Athletica Inc., LULU



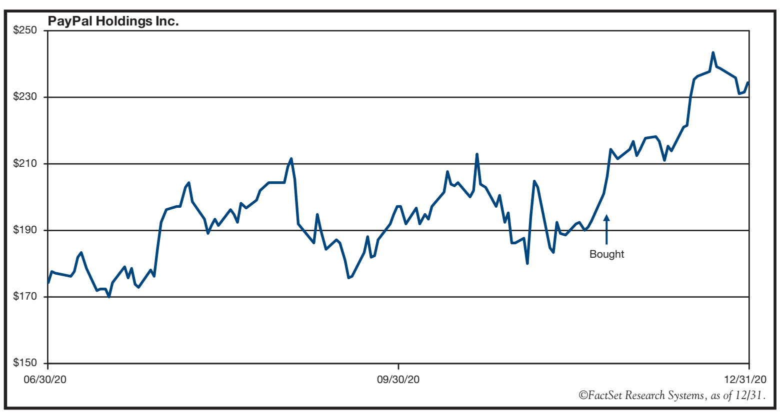
Hard to imagine a better example of a "strategic" acquisition. With pandemic conditions weighing on retail foot traffic and gym attendance, Lululemon moved to meet potential customers for its athletic apparel on their home turf. By acquiring home fitness start-up Mirror in June, Lululemon found a way to feature its brand in the homes of workout warriors while creating a completely new revenue stream.

Nasdaq-listed Lululemon Athletica Inc. calls itself a "healthy lifestyle inspired athletic apparel company for yoga, running, training and most other sweaty pursuits." The company operates 515 stores mainly in the U.S and Canada. Stores generate roughly two-thirds of revenue, with the remainder coming from direct-to-consumer sales. Revenue topped $4 billion in the 12 months through October.

Mirror is an interactive device that offers access to thousands of live and on-demand fitness classes. The sleek, wall-mounted display sells for $1,495, with users paying $39 a month for content. Subscriptions represent an entirely new opportunity for Lululemon in terms of scalable, recurring revenue. The company recently revised its estimate of Mirror's contribution to fiscal 2020 revenue to "in excess of $150 million" from its initial forecast of more than $100 million. About half of the Lululemon and Mirror customer bases overlap, representing an audience that seems likely to be receptive to efforts to boost brand awareness and drive membership growth.

Lululemon grew October-quarter earnings 21 percent, exceeding the consensus estimate by 32 percent. Revenue rose 22 percent, fueled in part by a 94 percent increase in direct-to-consumer sales. The company finished the quarter with $482 million in cash on its balance sheet.

PayPal Holdings Inc., PYPL



PayPal, acquired by eBay in 2002 and spun off in 2015, likely finished 2020 deriving as little as 5 percent of its total payment volume from the eBay marketplace. PayPal today is the largest digital platform for money transfer services, prominently featured as a payment option at the end of most online transactions. Less known is the company's growing presence at the front end of the purchase process – and the growth potential of PayPal's end-to-end vision.

Nasdaq-listed PayPal Holdings Inc. operates a two-sided technology platform that links its customers, consisting of both merchants and consumers, to facilitate the processing of digital payment transactions. The company hosted 361 million active accounts at the end of September, enabling payments and providing other financial services in more than 200 markets. Revenue increased 19 percent to $20.3 billion in the 12 months through September.

PayPal grew September-quarter earnings 75 percent, exceeding the consensus estimate. Revenue rose 25 percent due in part to a 38 percent increase in total payment volume. Upon announcing the results, Chief Executive Dan Schulman reiterated PayPal's goal to create "the most compelling and expansive digital wallet" encompassing "all forms of digital currencies and payments" in both physical and online settings.

Toward that end, PayPal launched a service to enable its customers to buy, hold and sell cryptocurrency, with plans to make it a purchase funding source at its 28 million affiliated merchants. The company broadened the scope of Venmo, a peer-to-peer payment platform by introducing the Venmo Credit Card. PayPal also expanded its "Buy Now Pay Later" efforts by introducing new interest-free, short-term installment products in the U.S. and U.K. Other technologies, including digital coupon clipping and touch-free QR code payments, also figure into PayPal's plans to deepen its customer relationships.

Assessing Risk is a Full-Time Endeavor

It might not be apparent on a given day or even a period spanning months, but this market is on edge. Underneath the buoyant optimism seen bobbing on the surface since investors decided the recovery from the pandemic outweighed the risks posed by it lurk serious threats to the upbeat outlook.

Fluctuating sentiment at times like these is often described in terms of risk tolerance, with a "risk on" attitude prevailing when investors invite risk and a "risk off" climate emerging when they no longer have the stomach for it. Problem is, change is often unforeseen and sometimes dramatic, so respect for risk must be unyielding.

That's why our approach to risk moderation is constant. From the way we isolate individual companies to the process we follow in building and managing portfolios, risk is an ever-present consideration in all that we do.

We're bottom-up investors, so we believe company-specific risk is the biggest threat to making 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. We're more confident in our ability to gauge a specific company's near-term earnings prospects through grassroots research than we are in our ability to predict how much a given industrial metal will cost six months from now.

Valuation risk is another factor that we strive to address one company at a time. We tend to be more conservative than a lot of growth managers in that we purchase companies at prices that we believe represent reasonable multiples of forward earnings estimates in order to minimize downside risk. We also maintain price targets that remain within our price-to-earnings ratio comfort level, meaning we might sell earlier than a more aggressive manager who is less sensitive to extended multiples.

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 portfolios from the bottom up, we often identify pockets of earnings strength concentrated in certain sectors. We remain alert to sector risk as we assess each new opportunity. To promote diversification and capitalize on the variety that exists on the sub-sector level, we limit individual industry exposure to 15 percent of portfolio 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 investment strategy is based on the premise that earnings drive stock prices. We isolate companies experiencing above-average earnings growth that, based on our research findings, show promise to exceed consensus earnings estimates. During normal market conditions, we look for companies with year-over-year earnings growth of at least 20 percent and upcoming catalysts that we expect to draw positive investor attention in the near future.

Exhaustive research is the key to our approach. We aim to build and maintain a comprehensive research mosaic for each company we hold through repeated interviews with company management teams and their customers, competitors and suppliers.

We employ a strategy that capitalizes on positive changes in individual-company fundamentals. Conducting our research with a consistent focus on risk ensures that the quality of the companies we isolate remains constant.

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 management teams, customers, competitors and suppliers

On the Cutting Edge

Every so often, we like to highlight examples of innovative ideas that cross your team's radar screen. Chances to capitalize on investment opportunities related to them may lie in the future or may never materialize.

Budding Promise for Pesticide Alternative

Benefits stemming from the use of pesticides include increased crop yields and improved food quality. The tradeoff is potential risk to human health and the environment, which is why finding an effective alternative to pesticides remains a widely pursued goal. There's promise in silicic acid, a compound naturally found in soil that helps boost a plant's immune response to unwelcome viruses and bacteria. But the current method of delivering silicic acid via liquid fertilizer can be too intense, stressing plants and harming helpful micro-organisms in the soil. Researchers at the University of Fribourg in Switzerland hope an alternative delivery system for silicic acid could lead to an alternative to harmful pesticides. The researchers created synthetic silicic acid nanoparticles, which in lab testing were more gently absorbed and effective in boosting microbe-thwarting defenses. Delivering silicic acid in nanoparticle form enabled the compound to do its work completely within the leaf system, avoiding the kind of stress that can arise when stems and roots get involved. The researchers reported that the nanoparticles proved to be totally degradable, meaning the silicic acid should not accumulate in crops or soil.

Magnetic Tape's Storage Capacity Keeps Expanding

A collaboration between IBM and Fujifilm confirms that the future of data storage remains a technology first introduced in 1952. Magnetic tape just keeps getting better. While recorded data increases by an estimated 30 to 40 percent each year, modern hard drive capacity expands at less than half that rate. For data that needs to be saved but not accessed instantly, magnetic tape is the best medium. Tape is energy efficient, reliable, secure, cost effective, durable and scalable. Now, based on the new prototype developed by IBM and Fujifilm, tape is also more capable than ever. The prototype cartridge can hold 317 gigabits per square inch of its ultrathin tape, which if unfurled would measure more than three-quarters of a mile. Representing a 57 percent improvement over IBM's 2017 record for gigabits per square inch, the cartridge's total capacity measures approximately 580 terabytes. For the prototype, Fujifilm developed a new tape material that replaces magnetic particles of barium ferrite with strontium ferrite particles, which take up 60 percent less space. That and other tape advancements enabled IBM to develop heads used to read and write data to the tape that set a record for accuracy.

Superfood for Smartphones?

Loaded with nutrients and healthy fat, flaxseed is widely considered good for you. In the right form and under the right conditions, researchers believe that flaxseed could be good for your cell phone, too. Colorless polyimide (CPI), a flexible alternative to glass used in bendable smartphones, is less prone to breakage than glass, but still susceptible to damage such as cracks and pinholes. A team at the Korea Institute of Science and Technology is researching whether flaxseed oil, also known as linseed oil, can be added to CPI in a way that creates a self-healing material. The researchers mixed linseed oil microcapsules with a clear silicone, called polydimethylsiloxane, to create a solution that they applied to a CPI film. Once dry, they stressed the CPI to its cracking point, in the process bursting microcapsules in the location of the damage. The oil filled and ultimately "healed" the cracks as it hardened into a transparent solid. The process was slow at room temperature, but subsequent experiments, such as exposing the drying solution to ultraviolet light, reduced the hardening time to 20 minutes.

High Hopes for Glucose-Responsive Insulin

For people with type 1 diabetes, managing their blood sugar is an ongoing balancing act. Insulin injections play a life-saving role in coping with the disease, but timing and dosage can vary in an inexact and potentially dangerous dance with the condition. Researchers at the University of Copenhagen are in the early stages of testing a novel insulin molecule that they designed to eliminate guesswork in administering the drug. Already recognized as a major achievement in chemistry, the team's molecule is glucose-responsive, able to independently increase or decrease its activity based on blood sugar levels circulating in a subject's blood. The molecule demonstrated efficacy in animal testing. While continued development and human testing will likely take years, hopes are high that the self-regulating molecule will make human insulin use safer and easier in the not-too-distant future.

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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 December 31, 2020, Builders FirstSource Inc., Commvault Systems Inc., Lululemon Athletica Inc. and PayPal Holdings Inc. represented 1.85, 1.75, 1.68 and 1.85 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Lululemon and PayPal at 3.05 and 3.28 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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