Looking Forward

Friess Associates market observations and insights

September 30, 2019

Steady Focus on Earnings as Volatility Makes a Comeback

On one hand, stocks reside in rarified territory. The S&P 500 Index ended September with the best start through the first three quarters of a calendar year in 22 years. More than a decade into its record run, there's recent reason to argue that the bull market remains spunky.

The other hand? Having cut rates in July and again in September, the U.S. Federal Reserve Bank (the Fed) was among 16 central banks worldwide that saw fit to make accommodative monetary moves in the third quarter amid global economic sluggishness.

Conflicting signals. Volatility, for reasons ranging from lingering to topical, is on the rise. As we embark on the final quarter of 2019, now seems an appropriate time to recall Mark Twain's 19th century observation about October: "This is one of the peculiarly dangerous months to speculate in stocks."

We put a lot of honest hard work into getting to know the companies we hold, so we're not big fans of the word speculate when it comes to investing. Still, we're taking a chance that our research legwork will pay off as part of an undertaking that, despite a long history of mostly cause-and-effect outcomes, offers no guarantees regarding the future.

Which brings us to the rest of Mr. Twain's quoted wisdom on risky months for stocks: "The others are July, January, September, April, November, May, March, June, December, August, and February."

Ongoing debate regarding Fed policy, heated by a persistent campaign of political outspokenness, is among the lingering reasons that volatility, which in the third quarter peaked to its highest levels since spiking late last year, should remain a familiar market characteristic in the near term.

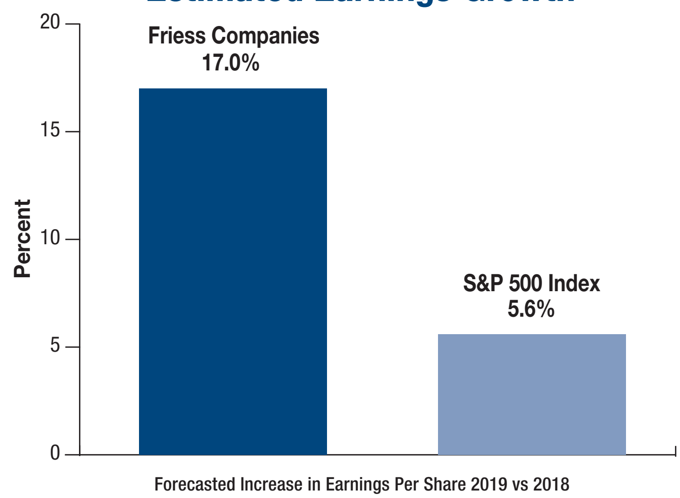
The Fed's most recent rate cut in September was accompanied by dissent among members of the Federal Open Market Committee (FOMC) on opposing sides of the policy spectrum, a situation last encountered six years ago. Such disagreement makes handicapping the central bank's intentions more challenging, increasing potential for volatility-boosting surprises.

The market's previous spike in volatility, by the way, was attributed to Fed-related worries and one of the primary contributors to them, trade tension between the United States and China. As of the writing of this letter, the standoff between the world's two largest economies continues with no end in sight.

We continue to recognize the risks posed by the trade war by limiting exposure to companies that are most at risk to fallout due to geographic and/or industry considerations. As we've seen since tensions began to rise more than a year ago, though, trade-related developments can elicit market-wide reaction in either direction.

Announced in late September, the impeachment inquiry against the president falls into the topical category when it comes to potential sources of volatility. While the market's unremarkable reaction at the outset was encouraging, the gravity and unpredictability of the situation make it likely that the high-profile proceedings will generate some market-moving commotion as things progress.

Estimated Earnings Growth



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

Monetary policy, trade negotiation and politics rank high among macro-level matters with potential to influence stock prices in the near term, but, beyond efforts to avoid obvious pitfalls related to them, we believe trying to make investment decisions based on them is imprudent.

Even the best informed minds on the subjects can do little more than make educated guesses. Plus, being right on a macro topic isn't particularly useful when predicting the resulting reaction can prove equally vexing. For example, positive economic news might reverberate negatively when the collective market mindset is focused on more accommodative action from the Fed.

Just as important, the influence of macro factors, while varied in duration, ultimately proves fleeting. The FOMC meets eight times a year, making decisions based on the latest data in each instance. Tariffs will be dropped or become permanent. The impeachment inquiry will run its course.

Meanwhile, every three months, into perpetuity as far as we can tell, companies will report their operational progress for all to see. Our investment strategy logically links the operational results of individual companies with their value as investments. We use earnings performance, the bottom-line tally of each company's ability to generate profits for its shareholders, as the ultimate measure.

This year continues to unfold as one of the more challenging in recent history in terms of earnings. Analysts predict that the companies of the S&P 500 Index will grow earnings just 5.6 percent in 2019, on average. As stock pickers focused on companies with above-average earnings profiles, we're still able to isolate robust growth potential in this moderate-growth environment.

Based on consensus estimates, the average company held in Friess-managed portfolios is expected to grow earnings 17.0 percent this year, or about three times the rate of the index. Since we aim to isolate companies that exceed expectations, the Friess portfolio growth rate forecast would be higher using our internal earnings estimates.

Ceridian HCM Holding (page 4) exceeded the consensus earnings estimate in four of the past five quarters as the company's evolution from its roots as a traditional payroll processor into a software-as-a-service provider progressed. Ceridian's main product called Dayforce, a cloud-based platform designed to automate human resource functions, is now used by more than 4,000 corporate customers.

Recurring revenue, which demonstrates the degree to which customers embrace and expand their subscription-based relationships with Ceridian, increased 31 percent in the three months through June. Cloud service represented about 70 percent of total revenue in the trailing 12 months.

With 544 warehouse locations in the United States, Costco Wholesale Corp. (page 4) is well known in its home market. The company, which boasts a profitable and growing footprint in foreign markets such as Australia, Japan, Mexico and the United Kingdom, goes to great lengths to introduce itself to locals anytime it makes inroads into a new market. Costco was especially methodical in opening its first store in China, a prized market with mixed results for foreign-company forays.

Costco introduced its brand to China in 2014, years before it selected a site for its first store. The company began exporting its reputation for quality products at value prices via sales through China's Alibaba online marketplace. By the time its first store opened in Shanghai in August, the location boasted 140,000 memberships.

Knowles Corp. (page 5) spent the last 50 years honing specialized technology for the hearing aid market. Knowles is a market leader in the MMS (microelectromechanical systems) space.

The company's low-profile, high-performance technology offers a combination of size and power consumption that is proving to be well suited for new applications as personal music consumption increasingly takes place via wireless earbuds. Knowles exceeded the consensus earnings estimate for the fifth consecutive quarter in the three months through June.

Where TTEC Holdings (page 5) once offered its customers the opportunity to offshore their call center operations, the company's longtime embrace of customer support technology and its diverse, widespread workforce now enable it to serve as the primary interface between its corporate clients and their customers around the globe.

TTEC offers a full range of interactive options, from online artificial intelligence chats to human-to-human conversations, across a comprehensive array of channels, including social media, in-app, voice and video, as customer touch points proliferate in the expanding digital economy. TTEC's June-quarter earnings more than doubled the consensus estimate.

We're working hard to ensure we hold a collection of companies poised to deliver earnings results that attract positive investor attention. Thanks for your confidence in our ability to find rapidly growing companies on your behalf.

Scott

Scott Gates
Chief Investment Officer

Uncertainty Breeds Conservative Capital Spending

Machinery manufacturer Caterpillar set a cautious tone on its first-quarter earnings call, saying that trade tensions called for more conservatism in its plans for capital expenditures, or capex. The company lowered spending to $547 million in the first quarter from $757 million in the same period a year earlier. With trade policy still unsettled, corporations in many different areas of the economy are keeping a watchful eye on how they deploy capital.

According to *The Wall Street Journal*, five of the 10 firms that spent the most money in capital outlays last year already lowered their spending forecasts by March 2019. Uncertainty regarding trade and the global economy are commonly cited factors.

Shares of FedEx Corp. fell in September after the worldwide shipper fell short of the consensus earnings estimate and cut its guidance for 2020. "Our performance continues to be negatively impacted by a weakening global macro environment driven by increasing trade tensions and policy uncertainty," Chief Executive Frederick Smith said at the time.

Capital expenditures are investments by a company to acquire, upgrade and maintain physical assets such as property, buildings, technology or equipment. They can include everything from repairing a roof to building a new manufacturing plant. The investments are made to create a future benefit and can typically be depreciated on the balance sheet, making them very different from the ongoing day-to-day expenses required to run a business.

It's the type of financial outlay that requires some planning, making it an indicator as to how a company or industry feels about demand in the months or years ahead. For example, the communications industry continues to aggressively build out datacenters as more workflow from enterprise moves off traditional servers and onto cloud-based platforms. While the trend remains strong, should demand for cloud-services from large businesses fade, we would expect to see some of these investments slow.

In another industry, a large ocean shipper benefits as new regulations associated with low-sulfur shipping fuel exacerbates an already tight market for tankers that move oil-related products.

The new International Maritime Organization, or IMO, 2020 regulation is effectively disrupting supply and demand dynamics for product tankers, creating inefficiencies likely to further strain tanker availability at a time when the order book for new product tankers is at a two-decade low. The ocean shipper spent roughly $800 million to add new product tankers ahead of the regulations going into effect at the end of this year.

Capex is set to grow 3.5 percent this year, down from the 4.2 percent anticipated just four months ago. The downward revisions compiled by Citigroup reflect the spending plans of 714 public U.S. companies.

Capex is often used as a rough gauge of future profits. Expenditures surged 11 percent in 2018 as companies capitalized on savings from that year's corporate tax cuts. Spending is set to expand, but the lower growth levels and recent downward revisions are beginning to worry investors that businesses could become overly cautious amid signs of slower economic trends.

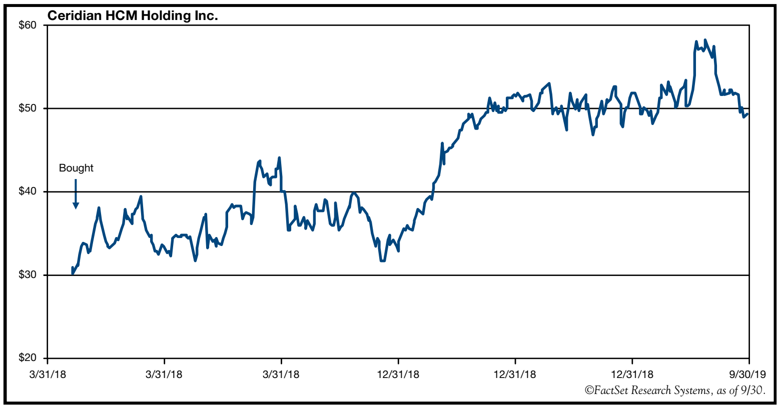
The spending slowdown is most pronounced in the communication-services and consumer-discretionary sectors, where capital spending fell from a year earlier. Spending growth also softened for some technology companies caught in the U.S.-China trade drama because they rely on Chinese demand and trade flows to drive revenue. One of the world's largest semiconductor manufacturers slowed its spending growth in the first quarter and lowered its estimate for the current fiscal year as inventories of memory chips grew.

Additionally, in recent months the year-over-year growth rate for inventories-to-sales has increased sharply. Similar to lower capex, rising inventory levels could point to a softer economic backdrop. Historically, rising inventories relative to sales can be interpreted as a sign that demand is weakening, potentially signaling the need for companies to reduce production and, likely, curtail capex.

There's a flip side to the story, as lower capital spending by a particular company or even an entire industry boosts cash flows, setting the stage for future growth. It's also part of the cycle in which companies with the strongest fundamentals should stand out.

In the end, the approach that individual companies take to capex as well as the overall strength of spending plans across the economy is something we watch closely. When, why and how investments are made in future growth will help shape the economic landscape going forward.

Ceridian HCM Holding Inc., CDAY



Back in 2012, when Ceridian's primary business was traditional payroll processing, the company acquired the Canadian software firm Dayforce. The purchase proved transformative, ultimately creating a software cloud platform focused on automating the human resource department. Cloud service generated more than two-thirds of Ceridian's revenue last year.

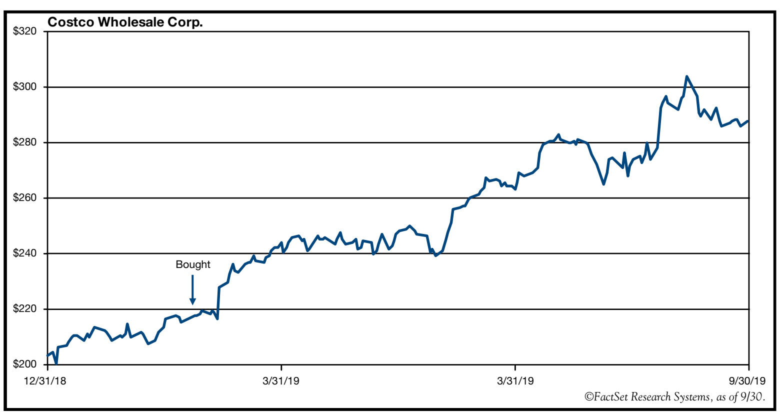
NYSE-listed Ceridian HCM Holding Inc. is a global human capital management (HCM) software provider that sells its products to customers through a software-as-a-service model. Dayforce, the company's flagship product, provides a full human resources, payroll, benefits, workforce management and talent management suite for organizations, regardless of industry or size. The company also offers a cloud payroll offering in the Canadian market called Powerpay. Revenue topped $774 million in the 12 months through June.

June-quarter earnings grew to $0.12 per share from a year-ago loss of $0.23 as revenue rose 10 percent. Earnings results surpassed the consensus estimate for the second consecutive quarter. Cloud revenue, including both Dayforce and Powerpay, increased 22 percent during the quarter as the company gained market share. Recurring revenue grew 31 percent.

A higher mix of larger customers joined the Dayforce platform in the three months through June. In addition to two international enterprise deals, Ceridian welcomed a 20,000-employee manufacturer and a 14,000-employee financial services company in the U.S. Total customers on the Dayforce platform reached more than 4,000 by the end of the period.

Ceridian's current guidance implies an acceleration in Dayforce demand through the end of the year. Based on the consensus estimate, Wall Street expects the company to post earnings of $0.49 per share this year versus a loss of $0.40 in 2018.

Costco Wholesale Corp., COST



Even as their governments remained locked in a trade war, consumers from the United States and China display kinship in their shared appreciation for a good deal. Costco, which opened its first store in China in late August, is a compelling case in point.

Nasdaq-listed Costco Wholesale Corp. operates a chain of 783 membership warehouses, with an average store size of 145,000 square feet. The company tightly manages overhead, including no-frills store designs and lean staffing, to deliver branded products and its own private-label goods at low price points to more than 97 million Costco membership cardholders. Revenue reached $149.6 billion in the 12 months through May.

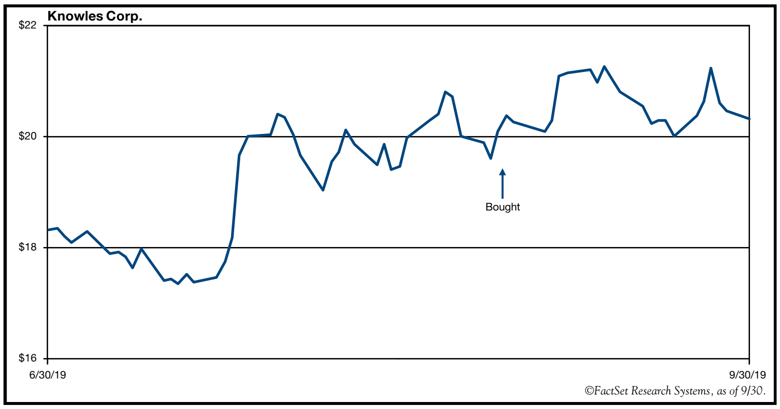
While the company derives the bulk of its revenue from the U.S. and Canada, Costco's overseas expansion is a strong source of investor enthusiasm. That's especially true about China, where the grand opening of Costco's Shanghai store generated a record day-one membership tally of 140,000 and attracted so many shoppers that the local government asked the store to close early due to traffic concerns.

Costco's approach to China, where big-box retailers such as Best Buy and Home Depot failed to gain traction, has been thoughtful. The company began establishing its brand in 2014 though China's Alibaba online marketplace, building customer recognition and anticipation for its brick-and-mortar launch.

Costco is unique in that international operations are more profitable than domestic, thanks in large part to its global sourcing infrastructure that makes it the largest buyer of most items it sells. That said, domestic demand remains strong, with same-store sales growing 6.2 percent in the August quarter, more than doubling the pace of overall retail growth.

Based on the consensus estimate, Wall Street predicts Costco will finish its fiscal year ended August 2019 with 20 percent earnings growth.

Knowles Corp., KN



According to industry data, about 1.5 billion mobile phones were sold around the world last year. Driven first by Apple and then by other companies like Amazon joining in, wireless earbuds keep gaining in popularity. Using a technology it first developed for hearing aids, Knowles is changing the way the premium wireless headphone is constructed.

NYSE-listed Knowles Corp. is a market leader and global provider of advanced micro-acoustic, audio processing and precision device solutions, serving the mobile consumer electronics, communications, medical, defense, automotive and industrial markets. The company is the market leader in MEMS (microelectromechanical systems) microphones.

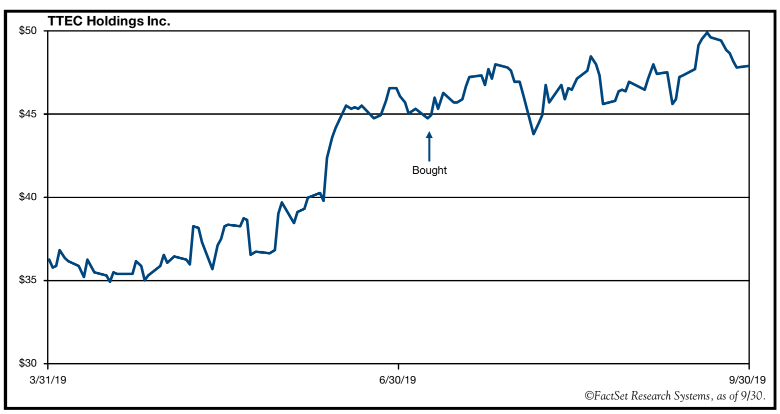
The company's audio segment, which includes MEMS microphones for consumer electronics and hearing health, accounts for more than 80 percent of revenue. Total revenue reached $845 million in the 12 months through June.

Strong demand in both its audio and precision device segments drove 22 percent June-quarter earnings growth, exceeding the consensus estimate. In audio, macro trends demanding better acoustic performance and edge processing resulted in higher content per device. In precision devices, sales reached record levels for the sixth consecutive quarter.

Management recently outlined the company's competitive position and the market opportunity related to its balanced armature speakers. Knowles speakers were developed for the hearing-aid market over the course of 50 years, and their size and power consumption make them uniquely suited for the wireless earbud market.

Amazon subsequently announced that it would release wireless Echo Buds, with integrated Alexa support, in time for the holidays that use two balanced armature speakers and contain other high-end features. As new products hit the market, Knowles expects profitability to continue to move higher.

TTEC Holdings Inc., TTEC



It's one thing to grow revenue by expanding into new geographic markets. Since every region presents its own challenges, providing customer support in new markets is quite another undertaking. TTEC, with 50,000 employees spread across six continents, stands ready to help companies deliver customer satisfaction wherever their business plans take them.

Nasdaq-listed TTEC Holdings Inc. is a customer experience technology and services company. The company offers everything from technology that facilitates automated interactions to highly trained representatives that serve as the interface between TTEC clients and their customers. With 89 customer engagement centers operating in 24 countries, TTEC employees interact with 3.5 million customers a day.

Founded in 1982 as an outsourced call center operator, the company boasts the experience, scale and relationships to make it one of the top picks as a customer care provider for Fortune 500 companies. Revenue neared $1.6 billion in the 12 months through June.

As a business process outsourcing company, TTEC was eager and early in adopting and shaping the kind of data-driven technology that pervades modern business. That background helped put the company on the leading edge of service solutions as customer touch points proliferate in the expanding digital economy. TTEC's platforms support all modes of engagement, including human, AI, human augmented by AI and other combinations, across channels such as social, in-app and web-based chat, SMS, email, voice and video.

TTEC grew June-quarter earnings 55 percent, exceeding the consensus estimate. Revenue rose 12 percent. Based on the consensus estimate, Wall Street predicts TTEC will finish 2019 with 23 percent earnings growth.

Portfolios that Represent Collections of Our Best Ideas

The most celebrated stock investors of all time didn't earn their reputations with never-miss strategies or spot-on predictions. Any investor who boasts a pristine track record today surely will be humbled sometime soon. Successful investing, at its core, results from being right more often than wrong.

From currency fluctuations to production disruptions, company managements regularly revise guidance that only seeks to set expectations for the next quarter – and those are the people who run the companies. Trying to consistently hit the mark as an investor from the outside looking in is a formidable challenge.

We don't hesitate to admit when we're wrong. In fact, being wrong plays a noteworthy role in our investment strategy. It's obviously not an outcome that we seek, but we're prepared for it because we know it comes with the territory. Not planning for the inevitable raises the risk of compounding negative consequences.

The underlying premise of our investment strategy is that earnings drive stock prices. It's more involved than that, but we ultimately believe earnings performance is the most important fundamental factor in determining each company's share price. Since we seek companies with improving fundamentals, we sell companies when they report deteriorating fundamentals or, in other words, prove our assessment of them to be wrong.

This is one of the key elements of our sell discipline, and we're pretty unforgiving about it. Opportunity cost prompts us to move on. Why should we wait around for a company to navigate itself through disruption when we could just as easily redeploy assets into a company that isn't currently under duress? There's nothing to prevent us from revisiting the troubled company sometime in the future when the outlook looks brighter.

That kind of comparative thinking – what we hold now versus what's available – carries into another important facet of our sell discipline: forced displacement. Each day we ask ourselves whether we're putting the assets we manage to their most productive use, based on the individual-company forecasts we develop through bottom-up research.

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. Forced displacement triggers a sale when assets from an existing holding are needed to fund the purchase of a new, more promising investment opportunity.

We want to hold companies that will generate enthusiasm among investors. Since we believe earnings drive stock prices, we aim to hold companies that surpass investor expectations. The risk that a company will disappoint investors rises as investor enthusiasm grows, so we also sell companies when we believe consensus forecasts overstate a holding's true potential.

The fourth and, in the order of this discussion, final trigger in our sell discipline is also our favorite. We set price targets based on the earnings forecasts we develop internally, and we sell companies when they reach them. We're valuation-sensitive, so our price targets tend to be more conservative than aggressive growth investors who are willing to shoulder increased valuation risk.

Our sell discipline is part of a broader strategy that stresses the power of individual companies to influence their share prices through operational performance. We capitalize on the relationship between earnings results and stock prices by isolating companies poised to deliver rapid earnings growth that enjoy good prospects to exceed Wall Street earnings estimates. To maximize upside potential and minimize downside risk, we focus on rapidly growing companies that also sell at reasonable multiples of earnings estimates.

The portfolios we manage represent collections of our best ideas at a given point in time. Change is a persistent theme as the backdrop evolves and companies enjoy various degrees of success in executing their plans. We perform continuous research in an effort to hold companies poised to surprise to the upside.

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 ideas that cross your team's radar screen appear here each quarter. Chances to capitalize on investment opportunities related to them may lie in the future or may never materialize.

Diagnosing Skin Cancer, Sans Scalpel

Research conducted at the Stevens Institute of Technology in New Jersey shows promise to bring relief to dermatology patients by reducing the need for biopsies, potentially disrupting the $5.3 billion diagnostic market for the nation's most common form of cancer. Researchers developed a technique using millimeter-wave radiation – short-wave rays that are also used in cell phones and security scanners – to evaluate whether a skin lesion is malignant or benign, a process that currently entails removing all or part of the lesion for lab testing. Cancerous tumors reflect more calibrated energy than healthy skin, like metal objects passing through an airport scanner. The researchers believe that the technology, which they proved viable using biopsied tissue provided by Hackensack University Medical Center, could cut the number of unnecessary biopsies in half. The ultimate goal is to incorporate millimeter-wave capabilities into a handheld device, which should be inexpensive to produce given its reliance on readily available technology. The rays can also be used to create three-dimensional tumor images, giving surgeons a reliable roadmap for excising all diseased tissue without trial and error.

Turning to Chemistry for Better Plastic Recycling

Of the myriad plastic items that mindful consumers drop in the recycling bin, only polyethylene terephthalate water bottles and high-density polyethylene milk jugs are likely to be recycled. The rest, representing more than 90 percent of all plastic waste, is incinerated, buried in landfills or cast into the ocean. Burdened with that knowledge since their high school days together, two friends now run a startup focused on improving the reusability of plastics. Menlo Park-based BioCellection uses a novel chemical technology to break plastic polymer chains down into organic acid compounds that can be harvested, purified and used as feedstock for new products. The process currently targets polyethylene, which covers more than one-third of plastics produced globally. BioCellection puts its technology to the test through a pilot program in cooperation with the city of San Jose and its waste-management contractor GreenWaste. The company is pulling flexible plastics, such as grocery bags, retail packaging and bubble wrap, from the trash heap to create the world's first plastic waste-derived chemical intermediates. The intermediates can in turn take on new life as clothing, carpet and other consumer goods.

Stroke Rehabilitation Device Inspires Patients to Put Best Foot Forward

People who suffer strokes typically experience muscle weakness or partial paralysis on one side of the body, resulting in disparities that affect their walking gait. Poor balance stemming from the asymmetry in their gait then puts stroke victims at heightened risk for falls and related injuries. A researcher at the University of South Florida believes a roller skate-like device he developed could be the key to restoring balance. Called the iStride Device, it resembles a modern version of the old clamp-on roller skates that attach over a wearer's shoes. The device is worn on the rehab patient's "good" side, with the limited motion wheels prompting the wearer to extend his or her walking stride. Each exaggerated step inspires compensation from the wearer's stroke-impaired leg, over time reducing asymmetry by increasing nerve activity and strengthening muscles. A recent clinical trial showed promise that the device could generate results superior to current rehab approaches using split treadmills since iStride can be used in real-word conditions as opposed a static setting. Hoping to build on the success of the first trial, the developer is currently conducting a clinical trial in which iStride is used by participants at home.

Stimulating Progress Against Hair Loss

Currently, the only treatments proven to be even modestly effective in treating baldness carry possible side effects, including sexual dysfunction, depression and anxiety. Engineers at the University of Wisconsin believe they've created a device that can deliver the same level of results without any observable risk. Nanogenerators are the secret to the low-cost, non-invasive device. The nanogenerators passively collect energy from the wearer's everyday movements, turning the energy into low-frequency electricity that they transmit into the outermost layers of the scalp. The flow of gentle stimulation then prompts dormant hair follicles to awaken. There's no need for cumbersome batteries since the wearer's motion generates the necessary power. That enables the device to be low-profile, small enough to hide beneath the crown of a baseball cap. Test results are similar to existing medicines in that the device, by reactivating dormant hair-producing structures, acts as an intervention to hair loss rather than a cure for full baldness. Having enjoyed success in tests on mice, the researchers hope to move on to human testing soon.

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As of September 30, 2019, Ceridian HSM Holding Inc., Costco Wholesale Corp., Knowles Corp. and TTEC Holdings Inc. represented 1.97, 2.03, 1.02 and 0.96 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Ceridian and Costco at 1.97 and 2.54 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held Ceridian and Knowles Corp. at 2.86 and 2.01 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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