Looking Forward

Friess Associates market observations and insights

September 30, 2021

Isolating Earnings Strength is a Year-Round Endeavor

It's official. The old Wall Street adage "sell in May and go away" is borne out by the facts. In its September 15 article "How the S&P 500 Turned $10k Into Either $78k or $3 Million," Bloomberg News reported: "Comparing the value of $10,000 investments in the S&P 500 Index from 1950, anyone who owned the S&P 500 in May through October would have ended up with about $78,000 based on total return. For November through April, the comparable total was about $3 million."

Sounds good. After a little more seasonal suffering, we should be in the clear come November, right?

Not so fast. Despite the article's contention that "seasonality does matter," the final calculation in the story delivers the real takeaway. Keeping the original $10,000 invested in the index year-round throughout the period ultimately generated $24.9 million.

From long-term historical patterns to market-moving events of the day, some investors cannot resist looking for an angle to outsmart the rest of us. More power to them – competing ideas and interests contribute to the inefficiencies that active managers like us look to exploit.

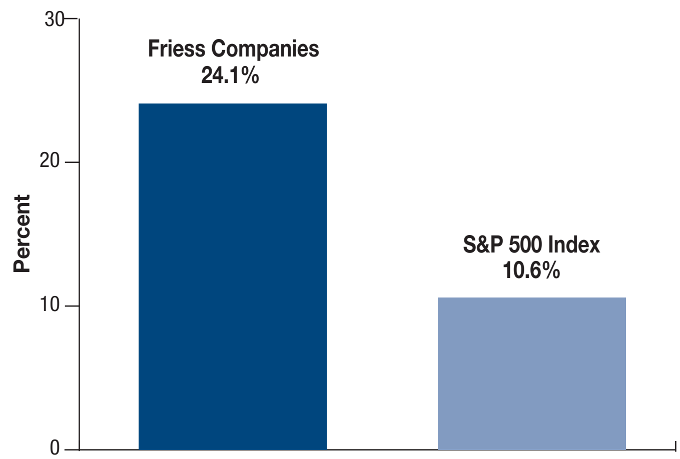
Still, the facts in this instance only reinforce our belief that consistent strategies yield better results over time. They add to our confidence that focusing on companies that stand out for earnings prowess and balance sheet strength will pay off in the long run, even when faced with near-term challenges that seem to indicate otherwise.

Consider the distraction caused by China Evergrande Group. The world's most indebted property developer rightly occupied the market's attention late in September when it became apparent that the company was ill-prepared to meet its latest obligations to banks.

In the debate that followed, most argued that on the scale of worst-case scenarios Evergrande was less likely to invite the kind of widespread pain of the 2008 Lehman Brothers bankruptcy than it was to mimic the course of the collapse of hedge fund Long Term Capital Management, which touched off a comparatively short-lived panic a decade before. Given the opacity of the Chinese system, who really knows? For the time being, investors appeared to trust China to contain any fallout.

Concerns about uncertainty related to the debt ceiling were also an obvious influence on market sentiment late in the period. No matter how accustomed the average citizen becomes to partisan politics, it is safe to say that professional investors do not take threats to jeopardize the nation's ability to meet its financial obligations in stride. The fact that the U.S. creditworthiness remained at risk of degradation was a big reason for the market's dour mood in September.

Estimated Earnings Growth



Forecasted Increase in Earnings Per Share 2022 vs 2021

Source: Consensus estimates from FactSet Research Systems Inc., as of September 30, 2021.

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.

Don't forget the Fed, either. The U.S. Federal Reserve Bank's shift toward a more hawkish posture no doubt ranks high among the primary topics of investor interest these days. Investors expect the central bank to begin tapering asset purchases before year's end and to raise interest rates next year. Bolstering that case, Dollar Tree announced that it would be adding more items with above-dollar price points.

Amid upward pressure on wages, freight and other inputs, a dollar just doesn't buy what it used to.

Given their potential to reverberate, the latest macro developments surely deserve notice. We're paying attention, but we won't be making top-down decisions based on our best-guess outcomes. To the extent that we can, we will be factoring in how broader trends could affect fundamentals among the companies we investigate, with the impact of inflation an obvious topic that we do and will continue to incorporate into our research work.

That said, we believe the most productive use of our time is to isolate individual companies that can continue to deliver solid growth as the backdrop evolves. Just as staying invested year-round was eight times more lucrative than following the "sell in May and go away" model, we think maintaining a constant focus on individual-company earnings trends is much more fruitful than trying to change course to suit ever-shifting macro winds.

For instance, Encore Wire (page 4) is capitalizing on a collection of concurrent secular trends driving demand for copper wire that don't appear likely to end anytime soon. Continued strength in homebuilding remains a major source of activity among the electrical contractors that represent the company's end customers. Infrastructure projects, including renewable energy facilities and electric vehicle charging stations, drive a growing share of aggregate demand.

Robust demand for wire and cable is evident in the price of copper itself. Long established relationships with raw material suppliers and a major in-house recycling operation help Encore remain a low-cost producer while maintaining enviable profit margins. The company's competitive advantages are further accentuated by its vertically integrated production facility, which gives Encore additional cost-control leverage over freight, in-process inventory and input costs.

Floor & Decor Holdings (page 4) continues to emerge as the class of the category as a flooring retailer. While big-box home improvement chains dedicate 3,000 to 5,000 square feet to flooring per store with limited onsite inventory, Floor & Decor is expanding its network of 78,000-square-foot warehouse locations at a rate of 20 percent per year. The company's buying power and direct product-sourcing relationships position it as a low-cost retailer, while the size of its stores enable it to stand out in terms of display space, selection and onsite inventory.

While Floor & Decor is already the largest flooring retailer by sales, smaller, independent operators represent the industry's majority, giving the company plenty of opportunity to win market share. Floor & Decor finished September with 153 stores in 33 states.

As an extensively embedded supplier to industries reliant on laboratory work, Thermo Fisher Scientific (page 5) was a near-immediate beneficiary of Covid-19-related efforts to develop and conduct testing and to produce therapeutics and vaccines. Much of that work is receding at this stage of the pandemic, revealing a core business that Thermo Fisher continues to steer toward high-growth areas in biotechnology and pharmaceuticals.

Thermo Fisher's largest and most profitable business unit, its life sciences solutions segment, grew 37 percent in the company's most recently reported quarter. Earnings jumped 44 percent.

Sonic Automotive (page 5) is one of the nation's largest automotive retailers, with franchised dealerships representing more than 20 different new vehicle brands and a separate unit offering one-to-four-year-old preowned vehicles. While most folks are by now aware of the supply shortages in the new and used car business, fewer seem familiar with Sonic's success in navigating the challenges.

Earnings more than doubled versus year-ago results in Sonic's most recent reported quarter, topping the consensus estimate by 69 percent. The company enjoyed record revenue at franchised dealerships and its EchoPark Automotive used car operation.

There are plenty of major matters to monitor as we begin the final quarter of 2021, including uncertainty regarding infrastructure spending, a natural gas shortage in Europe and the continued threat posed by the delta variant of the coronavirus. In addition to inflationary pressures among companies, we will remain diligent regarding valuations and supply chain issues in our bottom-up research. Please see page 3 for insights on recent supply chain challenges.

Thanks for your long-term focus and continued confidence. We are grateful for the opportunity to serve you.

Scott

Scott Gates
Chief Investment Officer

Tangled Supply Chain Slows Global Commerce

Production shortfalls in Asia and congested trans-Pacific shipping routes are constraining sneaker giant Nike's sales growth. FedEx explained inefficiency in its delivery network is partially due to rerouting more than 600,000 ground packages a day because of staffing shortages at distribution hubs. Demand for goods and services around the globe is improving in step with higher vaccination rates and less restrictive lifestyles, but the intricate systems designed to meet it are not yet up to the task.

The Institute for Supply Management found that nearly three-quarters of companies surveyed earlier this year were experiencing supply chain disruptions due to the pandemic. More than 44 percent of the companies surveyed didn't have a plan for how to handle a disruption from China. The situation has been especially difficult for businesses with complex supply chains, as their production is vulnerable to shortages of inputs from a multitude of geographies and businesses.

For example, more than a year into the shortage in global semiconductors, we're continuing to see just how deeply embedded technology is in consumer goods. Carmakers cancelled semiconductor orders when the pandemic first hit as demand for new cars dried up amid strict restrictions. Now, behind on production, automakers are competing with electronic device manufacturers looking to increase production. Compounding matters, the delta-variant wave of the virus is causing more production line delays at factories in Malaysia, Vietnam and the Philippines.

Toyota Motor, the world's largest automaker, planned worldwide production cuts of 40 percent in September because of the shortage in computer chips. Ford plans to idle a plant near Kansas City that makes its highly profitable F-150 pickup truck. General Motors stopped most of its truck production in North America because of the shortage.

Nike executives said on their quarterly call that it now takes 80 days, or twice as long as it did prior to the pandemic, to move a cargo container from Asia to North America. On any given day in recent months, there were about 70 container ships sitting off the West Coast ports of Los Angeles and Long Beach. The wait to unload them often stretches beyond three weeks at the two ports that move more than a quarter of all U.S. imports. Tens of thousands of containers are sitting at the ports waiting to be picked up.

The complex nature of the system, made up of shipping lines, port works, trucks and railroads, distribution hubs and last mile logistic providers, are all struggling to resolve the bottleneck. Near the end of August, the Drewry World Container Index, which provides weekly assessments of container freight rates, surged to $9,817 per container, representing a 351 percent increase from a year ago. Prices of shipping containers are on course to keep rising for the rest of the year, especially as the holiday season approaches.

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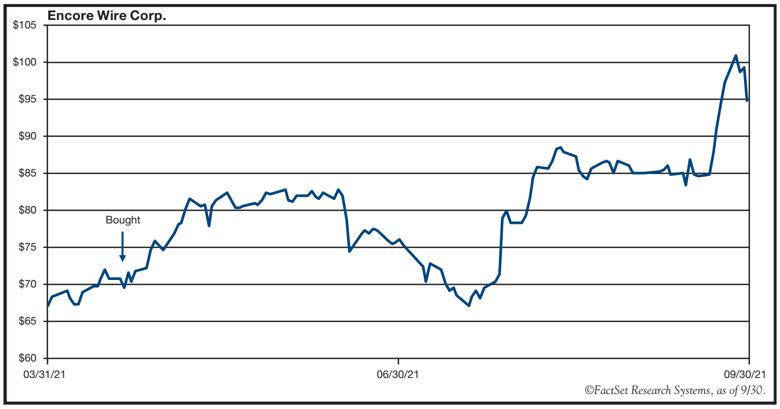
At the forefront of the problem is a shortage of workers across a wide group of industries. Frustration with employment prospects, safety concerns, expanded unemployment benefits and having kids at home all played a role. The West Coast ports are operating at only 60 percent capacity.

A shortage of truck drivers across the country means much of the container volume sits idle at capacity-constrained facilities. One of the nation's largest railroads recently reported surging demand in every business segment, but lowered expectations as turnaround times were impacted by understaffing. Despite aggressive recruiting and pay increases, the rail operator has not brought on even half of the people they had slated for this time in the year.

Manufacturers have been unable to keep up with increased demand because their suppliers can't source the necessary parts or raw materials. One of the largest suppliers of farming equipment recently told us that it was sending its own workers to a supplier's plant to help assemble combines and other equipment that farmers needed soon to harvest crops. In other instances, the company rented used equipment to customers willing to delay delivery of new equipment in exchange for first-priority status in the spring.

Restarting economies after a global pandemic is proving to be complex. Supply chains are dynamic and will adjust and improve, likely creating compelling investment opportunities along the way.

Encore Wire Corp., WIRE



"Electrifying" is probably not the first word that comes to mind when one thinks about the wire business. But considering it in the context of current trends in electrification, including solar energy and electric vehicle infrastructure builds, reveals that the seemingly mundane marketplace deserves some buzz. Moreover, Encore Wire shows that operating in the space with vision and discipline can generate shocking results.

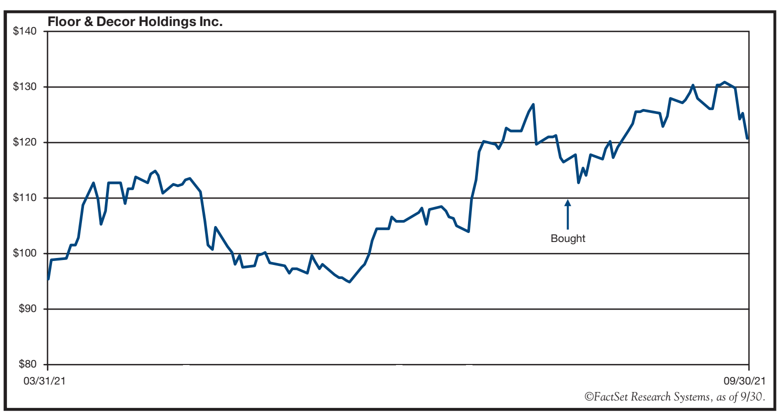
Nasdaq-listed Encore Wire Corp. makes copper building wire and cable. The company is a low-cost producer that conducts business through a domestic network of manufacturer's representatives and wholesale distributors that serve both the residential and commercial wire markets. Revenue jumped 62 percent to more than $1.9 billion in the 12 months through June.

We believe Encore is uniquely positioned because it controls the whole value chain, from raw material supply to product delivery. The company conducts all manufacturing and distribution operations from a single 449-acre campus, providing cost-control leverage over freight, in-process inventory and input costs. Encore ships orders within 24 hours, with a 99.7 percent order fill rate.

The company earned a record $8.82 per share in the June quarter, up from $0.60 in the year-ago period and ahead of the $1.38 consensus estimate. Increased volume and pricing drove results. The company finished the period with no debt and $158 million on its balance sheet.

We think Encore's sourcing relationships, production prowess and delivery capabilities position the company to benefit from continued demand driven by trends in remote working, renewable energy and homebuilding. Based on the consensus estimate, Wall Street predicts that Encore's earnings will more than triple in 2021 versus the prior year.

Floor & Decor Holdings Inc., FND



Floor & Decor held a grand opening on Long Island in mid-September. The company welcomed customers to its new store in Naples, Florida the next day. A week later, a similar scene unfolded in Waltham, Massachusetts. With a running goal to grow its store count by 20 percent each year, Floor & Decor seems unlikely to slow its rapid expansion anytime soon.

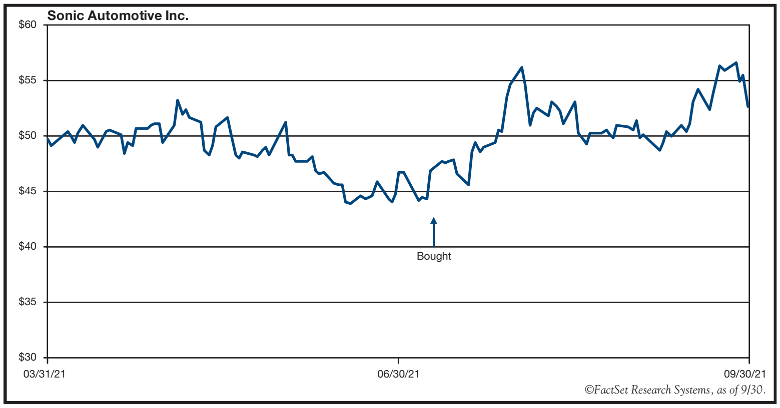
NYSE-listed Floor & Decor Holdings Inc. is a flooring distributor that operates 153 warehouse-format stores and two design studios in 33 states. Its stores, at 78,000 square feet on average, are much larger than its typical competition, giving the company advantages in inventory, selection, display space and economies of scale. Revenue rose 48 percent to nearly $3.1 billion in the 12 months through June.

Although Floor & Decor is already the largest specialty flooring retailer by sales, the $16 billion-plus hard-surface flooring market offers the company ample room to capture market share. After Home Depot, Lowe's, Lumber Liquidators and Tile Shop, smaller independent retailers still comprise most of the market. Floor & Decor's size and direct product-sourcing relationships with 240 suppliers in 21 countries enable the company to operate as the industry's low-cost retailer.

Floor & Decor earned $0.77 per share in the June quarter, up from $0.13 in the year-ago period and 22 percent above the consensus estimate. Sales increased 86 percent for the quarter, including a 68 percent gain in comparable store sales.

Based on the consensus estimate, Wall Street expects Floor & Decor to finish 2021 with 65 percent earnings growth.

Sonic Automotive Inc., SAH



An ongoing shortage of semiconductors and supply constraints caused by the coronavirus continues to impact the automobile market. With new and used cars scarce, pricing is up. Sonic's expanding presence in both areas is helping it benefit now and, we believe, as conditions normalize.

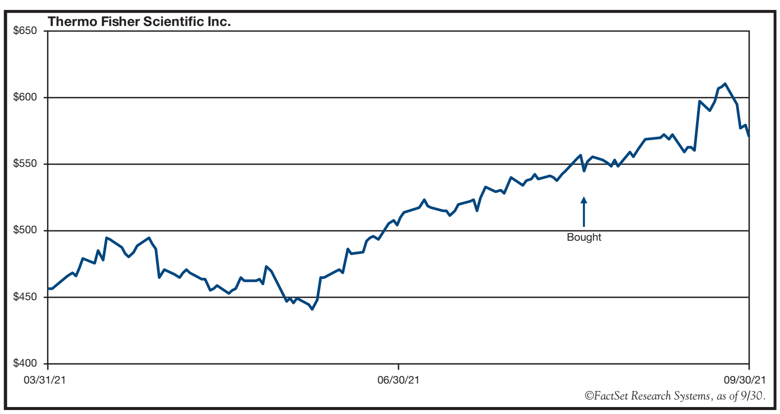
NYSE-listed Sonic Automotive Inc. is among the nation's largest automotive retailers. The company operates via two segments: franchised dealerships that represent more than 20 different new vehicle brands and EchoPark Automotive, which offers a unique car buying experience for one-to-four-year-old preowned vehicles. Sales grew 16 percent to $11.5 billion in the 12 months through June.

June-quarter earnings grew 114 percent, beating the consensus estimate by 69 percent. Sales jumped 59 percent to a quarterly record. Sonic achieved record sales at franchised dealerships and a fourth consecutive quarter of record revenue and retail unit sales volume at EchoPark.

We talked to Sonic management regarding the successful buildout of EchoPark. The division set a record with over $595 million in revenue, up 89 percent year-over-year. Halfway through a 12-month nationwide distribution network and digital expansion plan, the company expects to increase its customer reach 25 percent by year end. Additionally, the board of directors announced a strategic review for the segment.

Based on the consensus estimate, Wall Street expects , Wall Street expects Sonic to more than double earnings this year.

Thermo Fisher Scientific Inc., TMO



When the Covid-19 pandemic first hit, Thermo Fisher emerged as a leader in testing kits and, not long after, leveraged its pharmaceutical services leadership to support the production of therapeutics and vaccines. With virus-related demand declining, the company's exposure to the fast-growing biopharmaceutical market is becoming increasingly apparent.

NYSE-listed Thermo Fisher Scientific Inc. is the world's largest provider of laboratory solutions, serving more than 400,000 customers in the pharmaceutical, life sciences, clinical lab, industrial, food and environmental testing markets. The company leverages a comprehensive portfolio of lab products, scientific instruments and services to increase customer productivity and drive innovation. Revenue grew 33 percent to $35 billion in the 12 months through June.

June-quarter earnings grew 44 percent, topping expectations. Revenue rose 34 percent, including 27 percent organic growth in the company's base business (partially augmented by pandemic-related demand).

As the world shows signs of normalizing, non-essential procedures and projects that slowed with the spread of Covid-19 are returning. Following the closure of its acquisition of PPD, a global provider of clinical research services to the biotech industry, more than half of Thermo Fisher's revenue is expected to come from biotechnology and pharmaceutical sources. The company recently raised its three-year anticipated organic growth rate to 7-to-9 percent from earlier guidance of 5-to-7 percent.

Based on the consensus estimate, Wall Street predicts Thermo Fisher will finish this year with 27 percent earnings growth.

An Earnings-Driven Investment Strategy

Different investors approach equity investing differently. Dividend seekers generally crave the predictability of scheduled payouts, valuing a cut of current corporate profits over unsecured promise tied to future growth. Others identify with a vision, putting money behind ambitious undertakings before their path to profitability is established.

We believe there's a sweet spot somewhere in between. Dividend-paying companies are rarely investment targets for us because in many cases dividends mark a point in a company's lifecycle when returning money to shareholders is a better use of capital than investing to expand the business. Shares in money-losing companies often trade on sentiment, something no investor can gauge consistently.

The Friess Associates investment strategy is based on the straightforward premise that earnings drive stock prices. While many factors, including geopolitical developments, economic data and other macro forces, influence stocks for fleeting periods, our strategy counts on investors judging each company on its individual merits over the long haul.

Operational performance reveals how successful a company is in executing its mission and, since for-profit companies are in business to make money, no single detail is more important than a company's ability to generate profits for shareholders. Earnings results represent the ultimate measure of a company's performance.

Given that, earnings potential is the most important consideration in our process. The underlying assumption, based on market behavior that predates our firm's founding 46 years ago, is that strong earnings results attract positive investor interest, leading to capital appreciation or, said another way, share price gains.

In a typical earnings climate, we seek companies poised to grow earnings 20 percent in the year ahead. We also want to hold companies that we believe show more promise than the growth potential reflected in consensus earnings estimates compiled by Wall Street analysts. We find that sort of earnings upside is often associated with specific catalysts, such as new market opportunities, new products or a change in company management.

Earnings growth that results from creative accounting is of no interest to us. We look for companies with high earnings quality, meaning the earnings a company reports accurately reflect the conditions of its operations. We also analyze further to ensure that sound financial management practices carry through to each potential holding's balance sheet.

Still, no matter how good a target company looks after passing a series of fundamental hurdles, we evaluate the logic behind making a purchase within the context of price. We generally focus on rapidly growing companies that also sell at reasonable multiples of earnings expectations, usually less than 30 times forward estimates. The idea is to afford plenty of room for upside potential while mitigating downside risk.

Exhaustive, company-by-company research is the key to our earnings-driven approach. Friess researchers remain in constant contact with company management teams and their customers, competitors and suppliers. They conduct these "trade checks" in an effort to glean real-time insights on existing and potential holdings. Trade checks represent one of our most fruitful methods of idea generation, with research legwork often uncovering promising opportunities outside of the initial direction of our investigation.

We believe in the power of earnings so strongly that our active research effort serves to keep the portfolios we manage stocked with the best earnings potential we can isolate. That means existing holdings must continuously earn their keep by showing more upside potential than a new buy we're considering based on their respective fundamental outlooks. We aim to replace good ideas with great ones.

As an active, bottom-up manager, we use our company-level research findings to build portfolios one company at a time without regard to the composition of any particular passive index. Maintaining an individual-company focus typically results in portfolios with low correlations to benchmarks. After all, 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 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.

Energy-Saving Freezing Method Yields Fresher Food

Conventional freezing as a method of preserving tissues and organs for transplantation carries risk in that ice formation introduces the possibility that crystals could damage the biological materials prepared for storage or transport. The need to address that problem led a Cal Berkley researcher to develop a process called isochoric freezing, the principles of which he described in a study published in 2005. Now scientists at the University of California-Berkley are teaming up with the U.S. Department of Agriculture's Agricultural Research Service to apply the technology to food in an effort to improve quality, increase safety and reduce energy use. Isochoric freezing entails submersing an object, in this case food, in a liquid-filled, rigid-sided container. The liquid, such as water, keeps the food from exposure to below-freezing air, protecting it from the quality-depleting effects of crystallization. The technique can be applied with simple hard-plastic containers and requires no retooling of existing refrigeration equipment. Isochoric freezing can eliminate the need to freeze foods solid or quickly via flash freezing, reducing energy consumption. A U.S.D.A study estimates that changing over to isochoric freezing could reduce energy use by 6.5 billion kilowatt hours per year, eliminating carbon emissions associated with generating that power equivalent to removing 1,000,000 cars from the road.

Slender Mice Provide Clues in Fight Against Metabolic Syndrome

Researchers at the Harrington Discovery Institute at University Hospitals in Cleveland who identified a key hormone in regulating appetite five years ago are now testing how a drug designed to suppress the hormone might help prevent obesity and other conditions that can lead to heart disease, stroke, diabetes and other problems. The researchers previously discovered that the hormone, called asprosin, influenced glucose and insulin levels in the blood. Early studies showed that people with lower levels of asprosin experienced lower levels of hunger than people with higher levels, which was associated with a higher incidence of obesity, high blood pressure and insulin resistance. The researchers tested monoclonal antibodies designed to inhibit asprosin on mice with metabolic syndrome. Mice that received the treatments ate less, lost weight and showed normalized blood glucose. Given that the mouse-model research confirms what the researchers know about asprosin in humans, they're optimistic that eventual human trials will produce similarly promising results.

Glowing Plants Give New Meaning to Green Energy

A leading contributor to the field of "plant nanobionics," the Massachusetts Institute of Technology already counts explosive-detecting spinach, thirst-signaling flora and glow-in-the-dark watercress among the plants with added purpose its scientists engineered. MIT is now aiming to improve on its earlier efforts to add luminescence to living plants, which revealed that incorporating the substance that gives fireflies their glow yields less light than researchers hoped. The current work involves infusing strontium aluminate (a compound designed to act as a photoluminescent phosphor) nanoparticles into the pores of a living plant's leaves. The nanoparticles are coated in silica so as not to damage the plant or otherwise interfere with its natural functions. Testing showed that augmented plants exposed to the sun or LEDs glowed 10 times brighter than their firefly-based predecessors, with the glow lasting for an hour after as little as 10 seconds of exposure to a light source. Successful experiments involved basil, daisies, elephant ear, tobacco and watercress. With additional tweaking, the MIT team believes its glowing plants could one day illuminate outdoor spaces at night in a way that materially reduces the need for man-made electrical lighting.

Implant Helps K-9 Test Subjects Resurface Worn Joints

For patients who live long enough, joint replacement is an impermanent solution. Replacements performed early in life can require multiple revisions as recipients age, with each new replacement typically wearing out faster than the previous one. Cooperating researchers at Cytex Therapeutics, North Carolina State University and Washington University in St. Louis believe an implant they are developing could be a superior alternative. The textile-based implant is infused with a patient's stem cells, then incubated for over a period of weeks to spur tissue formation. After it's implanted, the three-dimensional woven structure slowly dissolves, leaving the engineered tissue to perform the role of cartilage. The implant reduced pain and restored joint function to baseline levels in a study involving dogs with moderate osteoarthritis of the hip. The early-stage results provide the researchers the confidence they need to pursue the additional work that will be needed to bring the technology to human testing.

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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.

For more information on Friess Associates, please visit www.friess.com.