Small/Mid Cap Growth

1st Quarter 2020

Market Review and Positioning

A remarkably strong 2019 is now firmly in the rear-view mirror and feels such a long time ago. The market had climbed a wall of worry and hit record highs despite uncertainties around trade wars and worries over policy errors by the Fed. But all those concerns pale in comparison to the public health and economic fallout from the Coronavirus pandemic. The first quarter is already one for the record books – a story of essentially two halves. The first half of Q1 continued where 2019 left off, with a robust economy and strong earnings growth all but assured. All that changed in a mere matter of three weeks. From its peak on February 19, 2020, the market sell-off that ensued ranks in the worst 0.25% of returns over a three-week span since 1926, though it is worth noting that the market has recovered those losses in the following year 75% of the time[1].

Large cap indices such as the S&P 500 returned -19.6% in Q1, while the Russell 2000 (i.e. Small Cap) Growth index returned -25.8% and returns from the Russell Mid Cap Growth Index fell somewhere in between (-20.0%) as investors sought safety in larger cap names. However, Growth continued to outperform Value over all market cap ranges in Q1 as a whole, as well as during the market downturn that commenced on February 20th.

PORTFOLIO MANAGEMENT TEAM

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The SMID Cap portfolio was down -22.76% (gross) and -22.97% (net) in Q1 vs. a -23.22% decline posted by its benchmark the Russell 2500 Growth Index – an outperformance of +46 basis points (gross) and +25 basis points (net). It also outperformed during the market sell-off. Between February 20th when the current downturn started and March 31st, the portfolio outperformed its benchmark by over +210 basis points (gross) and by +187 basis points (net). Gratifyingly, both sector allocation and stock selection were positive during the latter period.

In Q1 only two sectors within the benchmark (namely, Technology and Healthcare) outperformed, with all other sectors underperforming. We were overweight both sectors (albeit marginally in the case of Healthcare), which helped; as did the 3.4% cash balance in the portfolio. Likewise, three of our biggest portfolio underweights (Consumer Discretionary, Industrials, and Real Estate) also happened to be among the biggest laggards within the benchmark. In addition, as fundamental investors, we were especially pleased that stock selection across a majority of sectors was strong. That was the case in particular with the Consumer Discretionary, Communication Services, Industrials, and Technology sectors.

[1] Source: Empirical Research Partners

Outlook

The spread of the novel Coronavirus (COVID-19) is having a significant negative impact on the global economy and the shutdown that was initiated to contain it is exacerbating the stress. The oil price war is an additional burden that's led to cuts to global capital spending and has pressured high yield credits. The future and its precise trajectory are still unclear. How it all plays out would determine what equity returns are likely to be over the next 12-18 months.

The government and the Fed have initiated swift action to try and shore up the economy in the wake of the massive disruption the pandemic has caused. Rates have been cut essentially to zero, enough liquidity is being provided, and a fiscal stimulus package of $2 trillion has been enacted. US banks were adequately capitalized going into this crisis and personal balance sheets were also in better shape than they were at the time of the Financial Crisis. All these are powerful forces that can help at least partly mitigate the impact of this pandemic. What we believe can truly turn investor sentiment around would be the approval of a new treatment regimen.

Valuations are beginning to look attractive. On a trailing PE basis, valuation is now back to its 20-year average. Some of the other metrics look more compelling. For instance, the spread between the free cash flow yield of large cap stocks and the 10-year treasury yield exceeds 5% at present, which is the second widest on record.

It is already clear to us that the next couple of quarters are not going to be very pretty. What happens beyond that would depend on the length of the current shutdown. From a portfolio perspective, we are well-represented in companies that benefit from long-term secular growth trends such as cloud computing, personalized medicine, cost containment in healthcare, and innovation more broadly. Many of these are also relatively more insulated from the present situation or are beneficiaries to an extent. Over the last couple of years, we have moved away from brick and mortar retailers. Though it hurt us for a couple of quarters, the move eventually paid off as these retailers succumbed to secular challenges facing the industry. More recently (at the end of Q3), we saw that high yield and investment-grade corporate spreads were getting tighter relative to their own history. Our take was that the market was being too complacent with the tight spreads and that refinancing risk was not being priced-in correctly, and as a consequence we moved away from companies with above-average debt levels. We also moved away from companies with stretched valuations, and those that were growing fast but without generating much cash. All these steps taken together have helped us stay ahead of our benchmark during this crisis, and we expect them to continue to do so in the months ahead.

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LEADING CONTRIBUTORS

STOCK	AVERAGE WEIGHT	CONTRIBUTION TO PERFORMANCE
Teladoc Health, Inc.	1.86	1.17
Legg Mason, Inc.	1.14	0.37
Qualys, Inc.	1.73	0.19
Veeva Systems Inc Class A	1.48	0.18
Cable One, Inc.	1.70	0.18
Everbridge, Inc.	0.77	0.12
Zynga Inc. Class A	1.47	0.12
iRhythm Technologies, Inc.	1.27	0.08
Fortinet, Inc.	1.99	0.07
Guardant Health, Inc.	0.23	0.06

LEADING DETRACTORS

STOCK	AVERAGE WEIGHT	CONTRIBUTION TO PERFORMANCE
Arrowhead Pharmaceuticals	2.20	-1.32
Aimmune Therapeutics Inc	1.62	-1.05
Reinsurance Group of America	1.64	-0.98
Apergy Corp.	0.78	-0.93
Portola Pharmaceuticals, Inc.	0.87	-0.91
SeaWorld Entertainment, Inc.	1.18	-0.83
Western Alliance Bancorp	1.59	-0.77
Bausch Health Companies Inc.	1.30	-0.76
bluebird bio, Inc.	1.23	-0.71
IAA, Inc.	1.43	-0.65

The holdings identified do not represent all of the securities purchased, sold or recommended. Information on the calculation methodology and a listing of every holding's contribution to the strategy's performance during the period is available upon request.

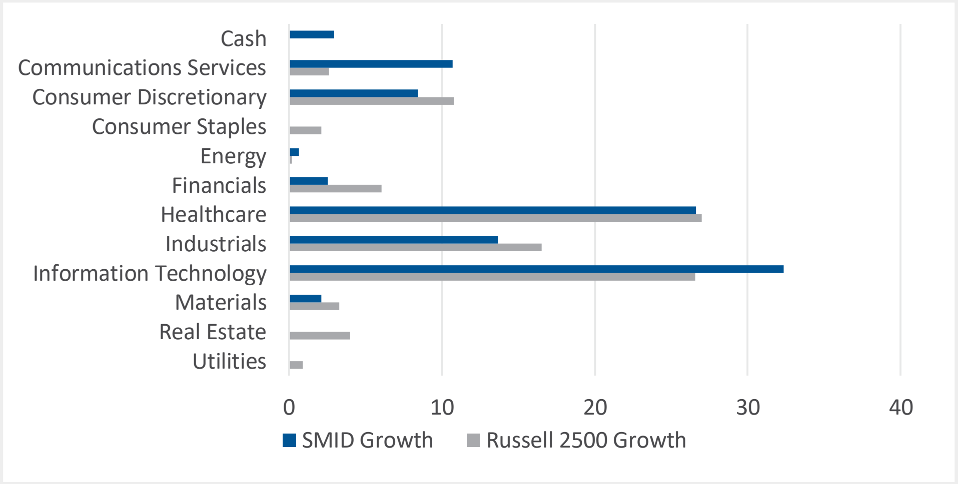
Positive Impacts

- Stock selection in Communication Services and Consumer Discretionary.

Negative Impacts

- Stock selection in Healthcare, underweight Energy.

Sector Allocation



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The Small/Mid Cap Growth composite was created on April 1, 2000 and includes all portfolios invested in U.S. equities (including ADRs) with strong earnings and growth characteristics and mid to small capitalizations. The product is benchmarked against the Russell 2500 Growth Index. The Russell 2500 Growth Index offers investors access to the small to mid-cap growth segment of the U.S. equity universe. The Russell 2500 Growth Index is constructed to provide a comprehensive and unbiased barometer of the small to mid-cap growth market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine growth probability approximates the aggregate small to mid-cap growth manager's opportunity set. The Russell 2500 Growth Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect growth characteristics. It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the costs of fees and expenses that will reduce returns. Typically, the Small/Mid Cap Growth portfolio is similar in composition to the benchmark except to the extent that the firm utilizes ADRs that are not included in the domestic index. Portfolios are generally comprised of individual stocks and cash equivalents. It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the costs of fees and expenses that will reduce returns.

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