



MARCH 31, 2019

CAMPBELL NEWMAN

# SMALL CAP GROWTH 1Q 2019 COMMENTARY

## MARKET OVERVIEW

The U.S. stock market entered 2019 a bit battered but in rally mode. The prior quarter's brutal sell-off resulted in multi-year lows in valuations amid deeply oversold conditions, laying the foundation for a broad-based rally that saw the S&P 500 report a 13.65% 1Q return. Growth outperformed value across market-caps in the quarter, with similar returns by style regardless of size. For example, the Small Cap Growth portfolio's benchmark, the Russell 2000 Growth Index, logged a 17.14% return in the period compared to the Russell 2000 Core and Value Index returns of 14.58% and 11.93%, respectively.

The yield curve remained fairly flat during the quarter, although points of inversion were evident toward the front end. Despite this, we believe one of the market's greatest worries was relieved on January 4 when Fed Chair Powell stated that the FOMC would abandon its previously outlined "dot plot" Fed Funds rate increases in favor of greater patience and data-driven decision making. Further relief to the macro picture came on February 24 when the Trump Administration announced an indefinite delay to its March 1 tariff increase deadline. Additionally, the generally positive tone of earnings reports added to the rally's progress. According to FactSet, 4Q 2018

earnings were up 13.4% compared to the year earlier period. About 70% of earnings reports exceeded estimates with the biggest surprises coming from Energy, Communication Services and Consumer Discretionary.

Considering the length of this bull market, the broad breadth of the recent rally is especially noteworthy. For example, using the S&P 500 as a market proxy, all 11 of the Index's economic sectors recorded positive quarterly returns in the quarter, while five sectors had performance >15%: Information Technology (19.86%), Real Estate (17.53%), Industrials (17.20%), Energy (16.43%) and Consumer Discretionary (15.73%).



## PORTFOLIO REVIEW

The Small Cap Growth composite's return of 14.74% underperformed its Russell 2000 Growth benchmark by 240 bps with stock selection in the Health Care sector making the greatest impact on relative performance, costing over 250 bps. The portfolio's Health Care sector return was 8.88% vs. 18.57% for the Index sector. The bogey's outsized returns were driven by unprofitable companies in the Biotechnology (26.71%), Pharmaceutical (18.27%) and Life Sciences Tools and Services (25.48%) industries. This is important because the strategy's stock selection methodology uses profitability as a key quality screen, excluding all companies that are unable to generate a profit over the last four quarters.

Stock selection in the Industrials sector cost almost 70 bps of relative performance, with a portfolio sector return of 8.80% compared to 13.84% for the benchmark sector. Dycom Industries, Inc.'s (DY) -14.99% return was the portfolio's worst in this sector due to an earnings disappointment last quarter.

The greatest positive impact (132 bps) to relative performance was derived from stock selection in the Consumer Discretionary sector, which recorded a 25.86% return compared to the Russell 2000 Growth's sector return of 16.33%. Pop culture consumer product maker Funko, Inc. (FNKO) was the top performer in the sector and in the portfolio during the quarter, at 65.17%. LGI Homes, Inc. (LGIH) and Ollie's Bargain Outlet (OLLI) were also positive contributors with returns of 33.22% and 28.30%, respectively.

The portfolio's overweight to the strong Information Technology sector added 42 bps of relative performance. Sector weights are a residual of the strategy's bottom-up stock selection process and show where the team had identified attractive investments.

The team remains constructive and believes stocks can continue to grind higher over time driven by earnings growth in what should continue to be a relatively low interest rate environment. Current estimates call for the broad market (S&P 500) to experience earnings growth of approximately 3% in 2019, with the lower year-over-year increase due primarily to the positive impact of tax reform on 2018 earnings growth and the expectation the Energy and Materials sectors will see a decline in earnings in 2019. In 2020, preliminary estimates call for earnings to increase by another 7%.

## TOP CONTRIBUTORS

**EPAM Systems, Inc. (EPAM)** continues to benefit from strong demand for its software product development and digital platform engineering services. The company generated 20% revenue growth in its latest quarter, the fastest revenue growth over the last 10 consecutive quarters.

**Five Below, Inc. (FIVE)** reacted favorably to the announcement that net sales for the holiday period increased 24.6%, from \$422.3 million to \$526.1 million in the same period last year. Comparable store sales increased by an impressive 4.9% over last year's figures.

**Ollie's Bargain Outlet (OLLI)** continues to buck the trend toward decline in brick-and-mortar retailing. The company reported F4Q revenue growth of 10% and earnings growth of 39%. Revenues benefited from a 13% increase in store count and comparable store sales of 5.4% during the quarter.

## BOTTOM CONTRIBUTORS

**Ligand Pharmaceuticals, Inc. (LGND)** underperformed as the market raised concerns about slowing sales, the ability of R&D projects to be fully funded and completed, and an increased dependence on less predictable milestone payments for growth. We believe these factors put LGND's revenue model at higher risk. With the stock still selling at 40x 2019 earnings, we see an unfavorable risk/reward and sold the stock from the portfolio.

**Dycom Industries (DY)** reported mixed F4Q results with revenues exceeding expectations while earnings fell far below. The company is facing a profit headwind from higher expenses associated with a large customer. That being said, DY should be able to manage through this difficult period and continue to benefit from the 5G investment cycle underway in the telecommunications industry.

**Cantel Medical Corp. (CMD)** underperformed as the company now expects its Lifesciences revenue to be down mid-single digits (prior guidance was flat), following cyclical headwinds and the decision of a key customer to move towards a dual-source approach. We view this slowdown in sales as only temporary and remain positive on CMD's long-term end-market growth opportunities as it gains share in the \$4.5 billion-plus medical market through product innovation and acquisitions.



## PORTFOLIO POSITIONING

The Small Cap Growth portfolio's composition changed modestly in the quarter, with turnover of just over 3%. The portfolio's emphasis remains in Information Technology with a 26.83% weighting (divided among a diverse set of 11

holdings) and Health Care with a 25.94% weighting (divided among 12 stocks). The Consumer Discretionary sector accounts for 13.02% of the portfolio, followed by the Industrials at 11.41% and Financials at 10.15%.

## TOP AND BOTTOM ABSOLUTE CONTRIBUTORS

### 1Q 2019 TOP CONTRIBUTORS

	WEIGHT	RETURN	IMPACT
EPAM Systems, Inc.	3.52%	45.79%	141 bps
Five Below, Inc.	3.83	20.54	104
Ollie's Bargain Outlet	3.49	28.30	92
PetIQ, Inc.	2.25	33.83	71
Funko, Inc.	1.22	65.17	64

### 1Q 2019 BOTTOM CONTRIBUTORS

	WEIGHT	RETURN	IMPACT
Ligand Pharmaceuticals, Inc.	0.43%	-18.41	-43 bps
Dycom Industries, Inc.	1.79	-14.99	-30
Cantel Medical Corp.	2.12	-10.06	-23
Corcept Therapeutics, Inc.	1.45	-12.13	-21
NV5 Global, Inc.	2.87	-1.97	-6

### SMALL CAP GROWTH COMPOSITE PERFORMANCE NOTES:

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