



SEPTEMBER 30, 2020

CAMPBELL NEWMAN

# SMALL CAP GROWTH

## 3Q 2020 COMMENTARY

### MARKET OVERVIEW

The Russell 2000 Growth Index (R2G) recouped its pandemic-induced losses during 3Q and closed the quarter with a 7.16% return. Many of the typical gauges of economic and financial health, while showing great improvement, were not the key drivers of the rally, in our view. Instead, we see the fuel driving stocks higher as:

1. The massive fiscal and monetary policy responses that injected over \$5 trillion of liquidity into the economy through the CARES Act and the Fed's quantitative easing,
2. The Fed's zero interest rate policy and its "we will do whatever it takes" commentary,
3. Improved optimism from:
  - a. The rapid and smoother-than-expected transition to work-from-home and other online commerce made possible by technology,
  - b. The ongoing development of improved COVID treatments and progress toward a vaccine,
  - c. The fact that the "worst-case" health and economic predictions did not come to pass, and the domestic economy was able to reopen, or at least begin the process.

In this environment, 8 of the 11 R2G's economic sectors recorded positive returns in the quarter though only four outperformed the benchmark: Consumer Discretionary (16.97%) performed best, alongside the Industrials (15.58%), Consumer Staples (9.94%) and Materials (8.42%) sectors.

Earnings estimates were slashed for the R2G during the first half of the year so that P/E multiples expanded as stocks rallied—from roughly 18.9x the 2020 estimate at the end of March to almost 29x at the end of September. Valuations backed off slightly from their August peak of about 30x due to a combination of lower stock prices and positive estimate revisions. For example, FactSet reported that the bottom-up 3Q S&P 500 estimate increased by 4.1% between June and



September, which represents the first positive bottom-up revision of the S&P 500 quarterly earnings estimate since 3Q 2018. The full-year 2020 and 2021 consensus estimates have been increased similarly.

## PORTFOLIO REVIEW

The Small Cap Growth portfolio's return outpaced its R2G benchmark for the quarter. The strategy is designed to participate on the upside and protect on the downside, with the goal of outperforming over a market cycle by investing exclusively in small cap growth stocks with a proven record of profitability.

The portfolio's Health Care sector contributed 204 bps to relative performance. The portfolio sector's return of 10.66% outperformed the benchmark return of 3.85%. Three stocks contributed to this performance: Horizon Therapeutics plc (HZNP), LHC Group (LHCG) and Medpace Holdings (MEDP).

The portfolio's Information Technology sector contributed 107 bps to relative performance. The portfolio sector's return of 8.46% outpaced the benchmark return of 4.14% with 7 of 11 holdings outperforming. Notable performers in the quarter included Virtusa Corp. (VRTU), EPAM Systems (EPAM) and Monolithic Power Systems (MPWR). The Virtusa position was sold after the stock reacted positively to a buyout offer from a private equity firm.

The portfolio's Consumer Discretionary sector contributed 93 bps to relative performance. The portfolio sector's return of 19.08% compared favorably to the benchmark return of 16.97% with 5 of 8 holdings outperforming. The portfolio's housing related stocks drove much of the performance: RH (RH), Century Communities (CCS), LGI Homes (LGIH) and Pool Corp. (POOL). Specialty retailer, Five Below (FIVE), contributed as well.

The portfolio's largest detractor was the Industrial sector with a 2.79% return vs. 15.58% for the benchmark, costing 148 bps of relative performance. Four of five sector holdings underperformed, with Knight-Swift Transportation Holdings (KNX) and Mastec (MTZ) recording negative performance. We view the relative performance of the holdings in this sector as short-term in nature.

## TOP CONTRIBUTORS

Shares of **Horizon Therapeutics plc (HZNP)**, a pharmaceutical company focused on rare and rheumatic diseases, reacted positively to strong 2Q results, highlighted by the rapid uptake of TEPEZZA, the first and only FDA-approved medicine for the treatment of Thyroid Eye Disease (TED). The company also increased its peak U.S. annual sales estimates for TEPEZZA to greater than \$3 billion from the previous estimates of greater than \$1 billion.

**EPAM Systems, Inc. (EPAM)**, a pure-play digital IT services company, is a major beneficiary of the drive by companies to digitally transform their businesses as they emerge from the COVID-19 pandemic. Improved demand and utilization drove the 2Q outperformance with revenues and earnings both growing mid-teens year-over-year.

**RH (RH)**, a leading luxury retailer in the home furnishings marketplace, outperformed in the quarter as the company reported revenue and EPS above street estimates driven by a record operating margin of 21.8% vs. consensus at 15.7%. Total demand strengthened through the quarter and the company now expects 2020 operating margin to be greater than 20% and have raised its long-term operating margin to approximately 24%.

## BOTTOM CONTRIBUTORS

**Ciena Corp. (CIEN)**, a global networking systems company, signaled a slowdown in order trends on its 3Q20 earnings conference call due to COVID-19, which will negatively impact revenue growth for the next few quarters. We continue to like the company, due to a combination of favorable long-term outlook in optical networking, industry leading technology driving market share gains, and considerable operating expense leverage to drive strong earnings growth.

**Syneos Health (SYNH)**, a leading integrated biopharmaceutical solutions organization, reported strong quarterly results, though, the stock underperformed in the quarter due to a 7 million share secondary stock offering completed on September 16 which disrupted the supply demand balance in the short-term. We expect the company to outgrow industry peers aided by a diversified global footprint and therapeutic expertise in high-growth segments.



Extreme value retailer of brand name merchandise, **Ollie's Bargain Outlet Holdings, Inc. (OLLI)**, reported 2Q20 results that were significantly above expectations with comparable store sales up 43.3%. Despite the strong showing, the stock underperformed in the September quarter as the company declined to provide guidance for the second half of the year. We remain confident the company is well-positioned to benefit from the continued disruption in the marketplace caused by the COVID-19 pandemic.

## PORTFOLIO POSITIONING

The portfolio's composition changed little during the quarter with turnover of less than 6%. A position in Lithia Motors

(LAD) was initiated while the Syneos Health (SYNH), Verint Systems (VRNT) and Virtusa (VRTU) positions were increased. The Horizon Therapeutics (HZNP) and EPAM Systems (EPAM) positions were trimmed. Additionally, less than a month after its position size was increased, VRTU was sold because it was announced that the company will be acquired by a private equity firm. The portfolio remains overweighted to Consumer Discretionary, Consumer Staples, Financials, Information Technology and Real Estate due to the constituent companies' strong bottom-up fundamentals. The portfolio is underweighted to Health Care and Industrials. It has no exposure in the Communication Services, Energy, Materials and Utilities sectors which, taken together, account for less than 7% of the benchmark.

## TOP AND BOTTOM ABSOLUTE CONTRIBUTORS

### 3Q 2020 TOP CONTRIBUTORS

	WEIGHT	RETURN	IMPACT
Horizon Therapeutics plc	5.05%	38.19%	210 bps
EPAM Systems, Inc.	4.64	29.13	150
RH	3.10	53.72	143
Virtusa Corp.	1.11	54.80	89
Pool Corp.	3.86	23.26	86

### 3Q 2020 BOTTOM CONTRIBUTORS

	WEIGHT	RETURN	IMPACT
Ciena Corp.	3.26%	-26.72	-97 bps
Syneos Health	2.78	-8.73	-49
Ollie's Bargain Outlet Holdings, Inc.	3.66	-10.55	-42
United Bankshares, Inc.	1.22	-21.11	-29
Lithia Motors, Inc.	0.56	-10.20	-17

### SMALL CAP GROWTH COMPOSITE PERFORMANCE NOTES:

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