Looking Forward

Friess Associates market observations and insights

June 30, 2017

The What-If Market

Call it a what-if market. At various times in the months since November, performance trends showed investors putting their money behind scenarios in a way that reflected confidence in the new administration's ability to make progress on business-friendly policies.

Some, such as corporate tax reform, contributed to the general environment, stoking positive sentiment that was good for stocks in general. Others appeared to take a more specific tack. What if banks were less regulated or energy producers could extract and transport resources with fewer restrictions? A $1 trillion infrastructure plan – that must be good news for engineering, construction, materials and so on, right?

All along, as many investors posited the beneficiaries of their government-inspired wish list, we embraced an assumption that stems from a different sort of question: What if none of this stuff happens?

That's not to say we're betting against any particular proposal or legislative outcome. We just try to find companies that insulate the portfolios we manage, to whatever extent is possible, from the vagaries of macro matters we can't control.

This administration, like every other, will enjoy degrees of success, failure and compromise as it promotes its agenda. As each final outcome comes into focus, investors who were quick to speculate on some other result will face reckoning.

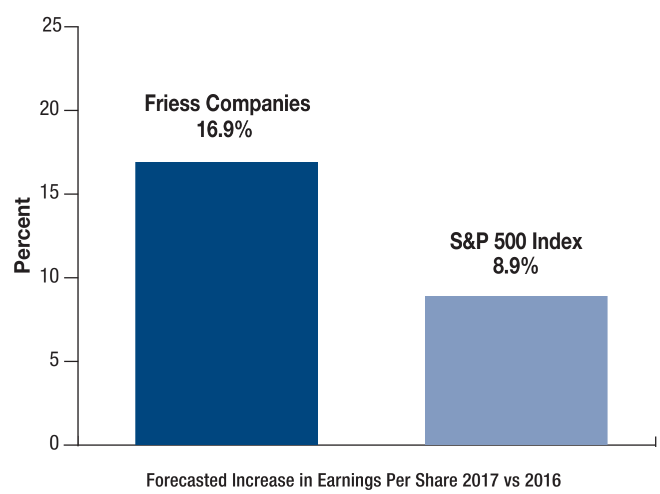
Handicapping a scenario, especially one that relies on the gears of government turning in coordinated fashion, is a lot different than investing based on a thorough assessment of one company's prospects. That's why, at a time when the market seems to be signaling some uncertainty about odds, timing and scope as they relate to the administration's platform, it's as important as ever for us to approach our work one company at a time.

That means finding companies with visible paths to earnings growth that they've established through company-specific means. These are companies that look forward to tangible catalysts unrelated to macro possibilities. Their tailwinds are secular trends, transformational movements that, despite normal, short-term fluctuations, maintain a positive trajectory over the long haul. If any of these companies happen to benefit from some government-driven action along the way, that's gravy.

Based on consensus estimates, the average company held in Friess-managed portfolios is expected to grow earnings 16.9 percent this year. The S&P 500 Index's average 2017 growth rate is 8.9 percent.

Whether it was enthusiasm for presidential possibilities, a more consistent earnings climate in recent quarters or some combination of the two, investors found reason to extend the second longest market rally in history through the first half of 2017. About 70 percent of the companies in the S&P 500 Index enjoyed year-to-date gains through June.

Estimated Earnings Growth



Source: Consensus estimates from FactSet Research Systems Inc., as of June 30, 2017.

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.

We're not breaking news in noting that valuations are stretched past historical norms. Shares of companies in the S&P 500 Index traded at 17.4 times earnings forecasts for the forward 12 months at the end of June. According to FactSet Research Systems, that's higher than the index's five- (15.3) and 10-year (14.0) averages.

Being valuation-sensitive, we think that's important (as we have for some time).

In and of itself, it's not cause for panic or defensive posturing, but it certainly warrants attention. When stocks sell at a premium, they need to prove themselves worthy of the added risk. Simply said, the stakes are higher.

The second-quarter earnings reporting season, probably the earliest and most telling test of the market's risk appetite at the start of the second half of the year, will already be underway by the time this report reaches you. A study released by FactSet at the end of June provided reason for optimism.

Negative preannouncements, when companies break bad news prior to their scheduled earnings releases, for companies in the S&P 500 Index regarding second-quarter results were 11 percent lower than the five-year average. At the other end, positive preannouncements, when companies tell the investment community to raise the bar, were 41 percent higher among index components than the five-year average.

The technology sector, which accounts for the largest commitments in the portfolios we manage due to the concentration of earnings strength we've identified there, boasts the highest number of companies that issued positive second-quarter preannouncements. In fact, the number of technology companies that made positive preannouncements was the third highest since FactSet began tracking EPS data in 2006.

The proliferation of technology in our daily lives puts Global Payments (page 4) in a position to profit from the secular trend toward increased use of forms of electronic payment. The position that Global Payments occupies is between your credit card or payment enabled smartphone and the networks that process payments after they're authorized at the point of sale.

Part middleman, part translator, the company's software solutions earn it a piece of every transaction. In addition to practical considerations such as convenience and security, banks and merchants encourage electronic transactions for the data they generate.

With customers such as Anthony's Coal Fired Pizza and Red Lobster, Performance Food Group (page 5) already serves some of the best known franchises in the restaurant industry. While big chains represent the bulk of the food distributor's business, the company is experimenting with its recipe in an effort to boost profitability.

Performance Food is increasing its access to more profitable independent restaurants by acquiring smaller, locally focused distributors. The deals enable the company to leverage its scale while providing new potential customers for its portfolio of private label products.

Children's Place (page 4) demonstrates how company-specific factors can lead to operational success, even amid tough conditions. In May, children's clothing apparel retailer Children's Place exceeded consensus earnings expectations with 48 percent April-quarter earnings growth. Its competitor, Gymboree Corp., filed for bankruptcy protection less than a month later.

Gymboree could close more than one-third of its store base, according to published reports. Children's Place, on the other hand, has been adjusting to changing retail conditions for years by increasing its digital capabilities and optimizing its store base by focusing resources on its strongest performers. Same-store sales in the three months through April represented the highest year-over-year gain for a fiscal first quarter for Children's Place in a decade.

Amid the excitement over discussions regarding a massive infrastructure spending push, no company that comes to mind better summed up the need to evaluate investments based on business trends as they stand today than Vulcan Materials Co. (page 5). The company makes construction aggregates, and a big part of its business is publicly funded infrastructure work, like highways and roads.

The company's presentation materials, in a section dedicated to estimating public demand, specifically points out that its forecasts don't assume "new, extraordinary commitments to investing in the nation's infrastructure." In other words, anything beyond the work that Vulcan Materials is already working on or bidding for on behalf of state governments and private sector customers across the southern U.S. is gravy.

Turning toward the second half of the year, we continue to isolate the most earnings strength in the technology sector. The consumer discretionary and health care sectors represent the next largest portfolio positions.

That's the case in the overall portfolio, but industrial companies play a more significant role in the small-cap portfolios we manage. In small cap, holdings from the technology, industrial and health care sectors represent the largest positions.

Thanks for your continued confidence. We appreciate the opportunity to serve you.

Scott

Scott Gates
Chief Investment Officer

Earnings Trends Draw Attention to Technology

Large technology stocks such as Facebook, Amazon, Apple, Netflix and Alphabet played a notable role in making the technology sector the market's best performer through the first six months of this year. These five companies were responsible for 24 percent of the S&P 500 Index's year-to-date return.

While the bear case is that hype is a big reason these companies and others in the technology sector seemed to defy gravity lately, a closer look at the situation appears to indicate excitement is warranted in many instances. Technological transformation marches on.

The majority of technology stocks in Friess-managed portfolios are somehow tied to delivering or enabling huge amounts of data to be used in ways that weren't possible even a couple of years ago. Amazon stands at the forefront of sweeping change. The company created what's now the world's most efficient order-fulfillment system, including a network of warehouses and its own logistics business.

An estimated 60 percent of American households maintain an Amazon Prime membership, demonstrating a level of appeal that is evident in falling profits and rising storefront vacancies among more traditional retailers. Grocery stores might be the next to feel pressure following Amazon's intention to buy organic grocer Whole Foods for $13.7 billion.

Netflix is at the center of the changes taking place in how consumers view television and video. In 2016, sales climbed 30 percent to $8.8 billion. Based on consensus estimates, they're expected to increase another 27 percent this year. The company's aggressive move into original content creating is credited with driving growth.

Netflix finished the first quarter with just under 100 million subscribers. While the company's U.S. operations could be approaching maturity, room for growth remains around the globe. The company now operates in just about every region of the globe, aside from China and a handful of other areas where it is blocked. No country outside of the U.S. accounts for a double-digit percentage of total revenue.

Advertising continues to morph as data proliferates. The Trade Desk is a pioneer in programmatic advertising, which uses huge amounts of data and software to improve the way marketing dollars are allocated. The company's revenue rose at least 70 percent in each of its first three quarters since its initial public offering.

Despite hiring and making investments in high growth areas, the company was also more profitable than Wall Street anticipated. The Trade Desk is making major headway in mobile, which now accounts for more than one-third of gross advertising dollars spent, and through international expansion.

Building out these networks and the new technology platforms that allow these trends to continue involves massive spending on data centers, telecommunications networks and cloud computing. Once considered a graphic chip maker for computers and video game systems, Nvidia Corp.'s high powered graphics processing units (GPUs) are increasingly being used in platforms that are challenging for traditional chips.

A closer look at the situation appears to indicate excitement is warranted in many instances.

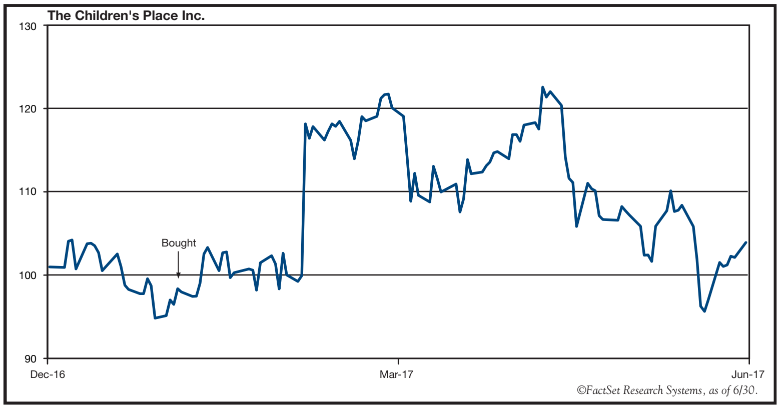
Nvidia Drive PX 2, for example, powers self-driving capabilities for Tesla Motors. The company's GPU platform is available in cloud services offered by Amazon, IBM, Microsoft and Alibaba.

As a maker of long-distance networking equipment, Ciena Corp. benefits as telecommunications companies around the globe upgrade their infrastructure to handle blossoming traffic. Ciena's April-quarter sales surged 57 percent in the Asia Pacific region and rose 7 percent in North America, led by strong demand for converged packet optical equipment. The company's products are used on high-speed connection platforms that connect data centers and connectivity hubs.

Oclaro, which also designs, manufactures and markets optical components, modules and subsystems for the telecommunications market, is exposed to similar trends. Investors reacted positively after China-based Huawei won a contract to build a new fiber-optic network for China Telecom. The project involves supplying a new generation of fast, secure and easily reconfigurable fiber technology to 21 of China Telecom's network hubs. Oclaro enjoys a long history of providing components that form the backbone of Huawei's solution.

From streaming videos to buying groceries online, anything that increases the need for more data, greater connectivity and higher capacity is also creating potential investment opportunities. Our overweight position in the technology sector during the first half of 2017 reflected our ability to find ideas capitalizing on this trend.

The Children's Place Inc., PLCE



Gymboree Corp. reported more than $900 million in debt when the children's apparel retailer filed for bankruptcy protection in mid-June. That's about 33 times the amount of debt Children's Place showed on its books when the company released its most recent quarterly results. Financial discipline is just one among many ways Children's Place is distinguishing itself from its competition.

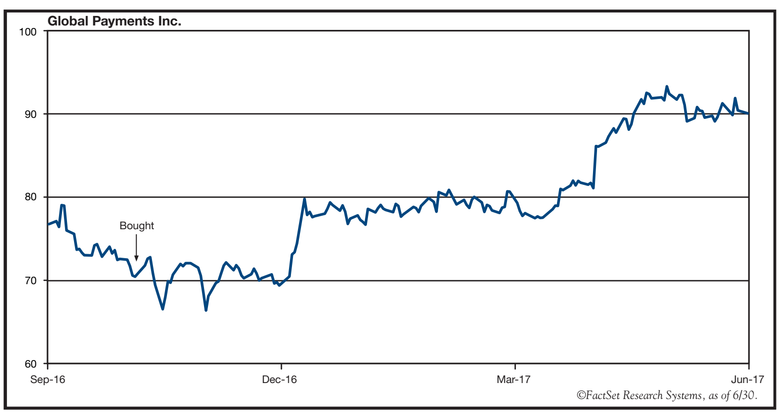
Nasdaq-listed The Children's Place Inc. is the largest specialty children's apparel retailer in North America. The company designs its merchandise, contracts its manufacturing and sells it through 1,033 store locations at value prices, primarily under "The Children's Place," "Place" and "Baby Place" brand names. Children's Place also sells through wholesale channels, licensing agreements, and franchise relationships in 18 countries. Revenue reached $1.8 billion in the 12 months through April.

On top of the competitive opening created by Gymboree's reorganization, opportunities for Children's Place stem from a multiyear effort to embrace technology to increase efficiency in inventory management and expand digital sales. The company also committed itself to optimizing its store base by focusing resources on its strongest locations while culling underperforming stores. Children's Place closed 149 stores since announcing the initiative in 2013.

At 6.1 percent, the company's same-store sales growth in the April quarter marked its highest year-over-year gain for a fiscal first quarter in a decade. Children's Place grew April-quarter earnings 48 percent, exceeding the consensus estimate by 19 percent. Chief Executive Jane Elfers credited progress with strategic growth initiatives – superior product, transformation through technology, alternate distribution channels and fleet optimization – for driving results.

Based on the consensus estimate, Wall Street expects Children's Place to finish its fiscal year ending in January 2018 with 33 percent earnings growth.

Global Payments Inc., GPN



We live at a time when the value of a purchase goes beyond the exchange of currency for a good or service. When a sale takes place today, data get stored and analyzed, turning transactions into intelligence that can be used to manage inventory, hire staff or otherwise adjust a business based on the behavior of its customers. Global Payments benefits as merchants increasingly use integrated solutions at the point of sale.

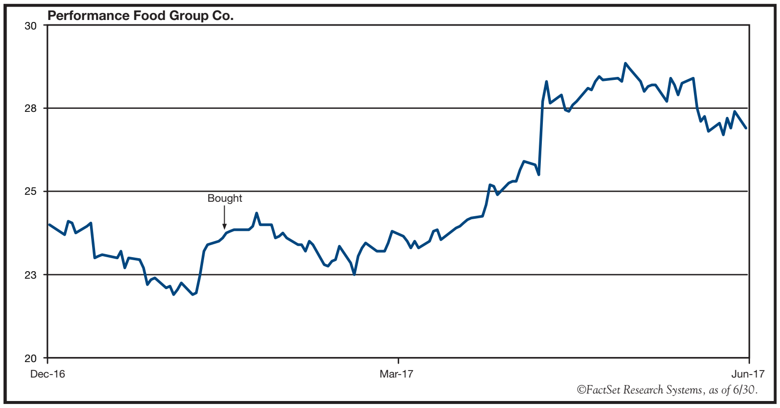
NYSE-listed Global Payments Inc. acts as a middle man between credit cards and transaction networks. The company offers a comprehensive suite of payment processing and technology solutions to businesses and financial institutions. Its technology is used at the point of sale in restaurant, hospitality, dental, education and other settings. Management's guidance, which incorporates the acquisition of competitor Heartland Payment Systems, forecasts 2017 revenue at $3.4 billion.

While Global Payments can be sensitive to overall consumer spending habits, the company's recent results demonstrate its ability to capitalize on the secular trends toward greater use of electronic payment forms and smarter point-of-sale systems. March-quarter earnings grew 33 percent, topping the consensus estimate. The company credited double-digit organic growth across its markets worldwide.

Your team met with Chief Financial Officer Cameron Brady to discuss the company's progress in integrating the Heartland acquisition, among other topics. The combined company increased its salesforce 10 percent since the deal closed in April 2016 and continued to make steady progress toward revenue synergies. Thus far, cross-selling opportunities for integrated solutions are a positive influence on operating margins.

Based on the consensus estimate, Wall Street expects Global Payments to finish 2017 with 23 percent earnings growth.

Performance Food Group Co., PFGC



Performance Food is a supplier to some of the best known restaurant franchises in the nation. In August, for example, the company closed a deal with Red Lobster worth an estimated $500 million. While chains generate the bulk of its revenue, Performance Food is set on changing its earnings outlook by catering to more independent customers.

NYSE-listed Performance Food Group Co. is the third largest food distributor in the U.S. It offers meats, dry groceries, refrigerated items and more through its largest segment, Performance Foodservice. PFG Customized distributes fresh products and provides logistics management and information system interface services. Through Vistar, the company distributes candy, snacks and beverages to offices, big box retailers and theaters. Customers include Anthony's Coal Fired Pizza, Shake Shack and Taco Cabana. Revenue reached $16.7 billion in the 12 months through March.

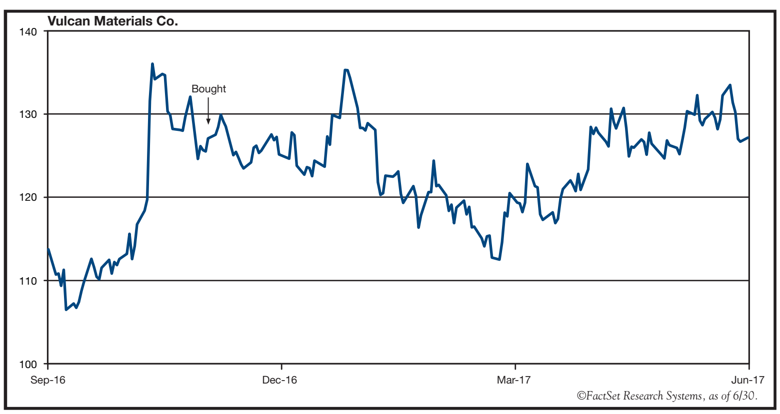
March-quarter earnings rose 80 percent, exceeding the consensus estimate. Volume growth approached 8 percent, with three-fourths of the total driven organically. Profitability improved with an increase in independent customers.

The shifting customer mix partly reflects recent acquisitions of specialty and local market distributors, providing access to restaurants Performance Foods might not reach otherwise. In addition to being more profitable, they represent an opportunity for the company to expand distribution of its higher-margin proprietary products.

Your team spoke with Chief Financial Officer Tom Ondrof regarding the company's ability to win market share while enhancing profitability. Performance Foods uses its scale to wield purchasing leverage with suppliers and manage delivery-related costs across its network.

Based on the consensus estimate, Wall Street expects Performance Food to finish fiscal 2017 with 23 percent earnings growth.

Vulcan Materials Co., VMC



Following the presidential election, share performance among companies with interests in large-scale construction projects reflected high hopes that pronouncements about massive infrastructure spending would lead to concrete action. While it remains to be seen whether the top-down talk results in bottom-line boosting work, Vulcan Materials appears positioned to forge a path to profit growth regardless.

NYSE-listed Vulcan Materials Co. makes construction aggregates, such as crushed stone, sand and gravel, and materials derived from aggregates, including asphalt mix and ready-mixed concrete. The company is the nation's largest construction aggregates producer, with 337 facilities in 20 states.

Revenue topped $3.6 billion in the 12 months through March. Vulcan generates about half of its revenue through public infrastructure work, particularly highways and roads. The company's coast-to-coast facilities network blankets the nation's fastest-growing states, and Vulcan makes opportunistic acquisitions with growth markets in mind. Three-quarters of U.S. population growth between 2010 and 2020 is projected to occur in Vulcan-served states.

Vulcan grew March-quarter earnings 31 percent, exceeding the consensus estimate by 73 percent. Demand was strongest in Southeastern and Mid-Atlantic markets, though the company was able to raise prices in nearly every state it serves.

After closing six deals for $230 million since last summer, Vulcan announced in late May that it agreed to acquire competitor Aggregates USA for $900 million. Chief Executive Tom Hill said the deal enhances Vulcan's ability to capitalize on increasing state highway funding programs in Georgia, Florida, South Carolina, Tennessee and Virginia. Private growth in the region is promising as well. Aggregates USA operates 31 facilities in the area.

Based on the consensus estimate, Wall Street expects Vulcan to finish 2017 with 44 percent earnings growth.

Background on a Buy: Mercury Systems

Friess Associates aims to capitalize on the relationship between earnings performance and stock prices by isolating companies poised for rapid, expectation-beating earnings growth. We believe pricing is a key consideration, so we focus on rapidly growing companies that also sell at reasonable multiples of earnings estimates.

Timing is also important. We try to time purchases so that we make the most of upcoming catalysts likely to attract positive attention and/or take advantage of an opportune entry point. Read on for an example of a buy made by our team.

Mercury Systems Inc. is a commercial provider of secure and safety-critical processing subsystems for defense and intelligence applications. It builds sophisticated subsystems that transform vast quantities of real-time streaming data generated by sensors on military platforms into actual intelligence. The company's specialized focus on defense electronics makes it a key outsourcing partner for prime contractors.

February 2015 – The Navy awards a preliminary design contract for SEWIP Block 3, one step in a $5.3 billion program to upgrade shipboard electronic warfare capabilities, to Northrup Grumman. Mercury Systems shares decline from their 52-week high because the contractor it worked with on Block 2 of the program, Lockheed Martin, did not win the assignment.

Legwork

In the following weeks and months, we interview the Mercury Systems management team on multiple occasions. We also interview defense contractors, including Boeing, Curtis-Wright, Honeywell International, Northrup Grumman, Lockheed Martin, L3 Technologies, Raytheon and Textron. Based on our findings, we believe that Mercury Systems is still positioned to win work through Block 3.

Entry Point

April 2015 – Mercury Systems issues 2016 revenue guidance that is 2 percent below the consensus forecast. The company's share price languishes as investors interpret the tempered guidance as confirmation of their Block 3-related concerns. Given the company's growing backlog, we view the guidance as conservative. More trade checks with management, customers, competitors and suppliers bolster our confidence.

Buy

July 2015 – We purchase Mercury Systems shares at a price that is, on average, 18 percent lower than the year-to-date high set at the market close February 11.

EPS Strength

August 2015 – Mercury Systems reports $0.18 per share in June-quarter earnings versus a $0.07 per share loss in the year-ago period, exceeding the consensus estimate by 50 percent.

The company ends up exceeding the consensus earnings estimate in each of the eight quarters that our holding period spans (as of June 30, 2017).

Cooperation

May 2016 – Mercury Systems announces the acquisition of a division of Microsemi Corp. The researcher responsible for Mercury Systems turns to his teammate with semiconductor expertise for insight. He later joins his teammate's meeting with Microsemi management, which provides insight into how Mercury Systems can benefit by leveraging its established salesforce.

Continuation

May 2017 – The Mercury Systems management team visits Friess Associates as part of its ongoing relationship with the Friess research team. Research interviews with competitors, customers and suppliers continue as well.

Hold or Sell?

A company's status as a holding in a Friess-managed portfolio is primarily determined by its ability to earn its keep. A holding earns a place in the portfolios we manage by showing a more promising fundamental outlook than the steady supply of new ideas that the Friess research team generates. We want the portfolios we manage to represent collections of our best ideas.

Additionally, we sell companies when they reach price targets that we set based on our in-house earnings forecasts. We hold companies that we believe will report positive operational results, so we don't hesitate to sell the ones that prove our assumptions to be wrong. We also want companies with favorable odds to exceed consensus earnings estimates, which leads us to sell holdings for which we believe Wall Street expectations overstate their realistic potential.

On the Cutting Edge

Examples of innovative and interesting ideas that cross your team's radar screen make it into this column each quarter. The chance to capitalize on investment opportunities related to them may lie in the future or may never materialize.

Very Smart Ring

Wearable technology like fitness trackers that count your steps, monitor your heart rate and ping when you have a new email are just about ubiquitous at this point. Tokenize, a biometric security startup in Rochester, N.Y., aims to take wearable tech in a new direction. The company's Token Ring is designed to work seamlessly as a credit card, house key, desktop log-in, smart-car key, password vault and office access badge. Made of sterling silver, the Bluetooth compatible ring is embedded with an optical sensor to read a fingerprint and uses near field communication to let its wearer unlock electronic devices instantly. The unique ring acts as a secure wearable wallet, keychain and identification. Authentication company HID, the FIDO alliance, Microsoft, MasterCard and Visa are already onboard with Token Ring technology. The Token Ring already works to authenticate public transportation access in 40 systems around the world, with 20 more coming in 2018. Starting at $249, the ring is slated to ship in late 2017.

Gecko Garbage Grabber

Engineers at Stanford University are turning to nature to assist in cleaning up massive amount of "Space Junk" that is currently orbiting the planet at speeds up to 17,500 m.p.h. Sharing space with an estimated 500,000 pieces of floating debris, astronauts occupying the international space station can be at risk due to collisions with this junk, so researchers devised a new robotic gripper inspired by the microscopic flaps on a gecko's foot. The specially-designed gripper has a grid of adhesive squares that can stick to various objects, shapes and materials, including solar panels, rocket parts, fuel tanks and satellites. This innovation enables versatile and efficient maneuverability, creating a much safer and controlled way of collecting and disposing of space debris.

Voice-Activated Tech for Custom Experiences

IBM's Watson and Harman Professional Solutions are teaming up in an effort to outfit conference rooms, hotels, hospitals and other locations with connected, voice-enabled, in-room cognitive concierges. The technology will allow users to control the room hands-free. For instance, a hospital patient will be able to operate the lights, blinds, and ask questions about the hospital and physicians, while allowing nurses and other medical personnel to focus on more pressing tasks. Hotels and hospitality venues will benefit from the technology by allowing Watson to assist with checkout, reservations, directions and more. Thomas Jefferson University Hospitals in Philadelphia is currently working with IBM to use Watson's technology to help patients customize their hospital stays to create more comfortable, personalized experiences.

Tick Spit Could Fix Troubled Tickers

A study from the University of Oxford says that tick saliva shows promise as a potential treatment for a potentially fatal heart disease. Called myocarditis, the disease generally affects young adults whose hearts become infected because of a common virus. About 30 percent of people with myocarditis eventually experience heart failure, according to the University. As a result of infection, the heart releases chemicals called chemokines, which trigger dangerous inflammation. Proteins in tick saliva called evasins enable ticks to feed from their hosts without causing inflammation. Researchers zeroed in on one particular evasin that binds with chemokines and blocks their effects. The University hopes the findings represent an early step on the way to therapies for myocarditis and other inflammation-related diseases.

This Won't Hurt A Bit

Researchers from Emory University began testing a micro-needle patch vaccination for influenza. Currently in a phase 1 clinical trial, the micro-needle patch provides a syringe-free opportunity for immunization. Each patch contains approximately 100 micro-needles that are minuscule enough to deliver vaccine without causing pain. The patch ultimately dissolves into the skin, making it safe enough to administer at home. Researchers hope that the patch can appeal to needle-averse patients while being accessible enough to help reduce the burden of patient travel to clinics and hospitals to receive vaccines.

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Earnings growth rates quoted refer solely to the estimated earnings growth rates of the average investment holding of Friess Associates based on consensus estimates. 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. Diversification does not guarantee a profit or protect against a loss in declining markets.

As of June 30, 2017, Alphabet Inc., Amazon.com Inc., Ciena Corp. Facebook Inc., Global Payments Inc., Mercury Systems Inc., Netflix Inc., Nvidia Corp., Oclaro Inc., Performance Food Group Co., The Children's Place Inc., The Trade Desk Inc. and Vulcan Materials Co. represented 2.19, 1.99, 1.07, 2.01, 1.71, 0.44, 1.62, 1.46, 0.99, 1.20, 1.05, 1.67 and 1.41 percent of AMG Managers Brandywine Fund's assets. AMG Managers Brandywine Blue Fund held Alphabet, Amazon, Global Payments, Nvidia, Netflix and Vulcan Materials at 2.72, 1.99, 2.06, 3.41, 2.45 and 1.87 percent of assets. AMG Managers Brandywine Advisors Mid Cap Growth Fund held Children's Place, Ciena, Global Payments, Mercury Systems, Nvidia, Performance Food and Vulcan Materials at 1.73, 1.96, 1.98, 1.05, 2.52, 2.01 and 1.71 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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