GW&K INVESTMENT MANAGEMENT

PORTFOLIO MANAGER Q&A | SEPTEMBER 2020

SMALL CAP GROWTH STRATEGY

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ABOUT OUR STRATEGY

The GW&K Small Cap Growth Strategy focuses on companies with a market cap at purchase between $250 million and $4 billion or within the range of the Russell 2000 Growth Index. Through a disciplined research process, we seek out companies that have a dominant or strengthening position within a niche market, exhibit sustainable and above-average growth, and whose shares trade at reasonable valuations. We are insistent about the sustainability of earnings growth as we believe it is often overlooked and not properly recognized by the market. We invest for the long term and aim to provide clients with a fully diversified portfolio that participates in rising markets and protects returns when markets decline.

- **Strategy Assets: $535 MM**
- **GW&K Domestic Equity Assets: $6,536 MM**

Assets as of 6/30/20

JOSEPH C. CRAIGEN, CFA

Despite the volatility caused by a global pandemic, small cap growth stocks did extremely well in the second quarter of 2020, including the GW&K Small Cap Growth Strategy. With a return of 29.7% for 2Q20, this was the Strategy's strongest quarterly move since inception. To what do you attribute the bounce back in performance?

Mr. Craigen: One thing that we focused on during the selloff was continuing to follow our disciplined process and our philosophy of taking a long-term approach to investing in high quality companies. One of the ways that manifested itself was that we stuck with some of our biggest detractors from the first quarter because they were still very good businesses. We had a number of companies that sold off dramatically during the first quarter, but then turned into strong performers in the second quarter as the economy reopened and demand trends (or business fundamentals) improved. As a result, we were able to participate in what turned out to be a low quality market rally.

While small cap stocks might typically be seen to have greater volatility than large cap stocks, they also offer greater upside. During this period of economic uncertainty, how important is it that investors have an allocation to small caps?

Mr. Craigen: Yes, large cap stocks are generally thought of as less volatile than small cap stocks. We witnessed that with the market action earlier this year when large caps outperformed small caps during the selloff. But as you alluded to, there are two sides to the risk/reward coin, and the other side is that small caps often lead in a rebound. That's been evident this year as small has outperformed large since stocks bottomed in March. However, large caps still retain a sizable lead for the year-to-date period of more than 1,000 bps through the end of September. Looking forward, if one believes that the economy will be in a better place a year from now, history indicates that small caps should also be in a better place a year from now, both in absolute and relative terms.

How do you differentiate your Small Cap Growth Strategy from other small cap growth strategies out there?

Mr. Craigen: There are a number of items that come to mind, such as our long-term approach, our focus on finding companies that can produce consistent and sustainable growth, and our discipline on valuation. However, one item that stands out is the emphasis we place on management. We put a lot of effort into finding management teams with the experience, intelligence, and passion that can result in their companies becoming much larger organizations. And we're in a great position to execute on that philosophy as every person on our investment team has been doing this for well over a decade. That amount of experience is critical. Anyone on our team can sit across the table from a management team and make judgements about whether this is a group that we want running our companies.

As a bottom-up investor what do you look for in a stock and how do you know when to buy and when to sell?

Mr. Craigen: First and foremost, we're looking for a really strong management team. And

having the ability to make those professional and personal assessments about an executive team is one of the most important reasons why we have such an experienced group of stock pickers. Beyond that, we're looking for good businesses playing in attractive end markets, with differentiated products and services that will enable them to be long-term winners in their respective fields and generate attractive financial performance.

Once we've found a company with those attributes, we want to invest at a reasonable valuation, and we can be quite disciplined about waiting for the right time. This year offers a number of examples on that front where we've actually known some companies for years, but always thought the valuation was a little too expensive. We then used the market selloff this year as an opportunity to finally invest.

As for the sell-side, we'll exit a position when the company no longer has the attributes that attracted us to it in the first place such as a change in management that we think is for the worse or the competitive environment is about to become more challenging. And actually, many of our sells are forced on us due to an acquisition or a company exceeding our market cap thresholds. We're quite disciplined about maintaining our status as true small cap growth investors. When a company gets too big, we sell it and look to re-deploy the proceeds in another stock that fits within our market cap mandate.

Growth stocks have outperformed value stocks for some time now. How has that trend persisted in 2020?

Mr. Craigen: Small cap growth stocks have beaten their value counterparts by a wide margin this year. Much of that has to do with the downturn and the associated governmental response. Growth stocks are often sought out by investors during recessionary environments as the fundamentals of these businesses often do better than the more economically sensitive stocks that populate the value indexes. This preference was amplified this year by the rapid implementation and magnitude of fiscal stimulus. The sharp reduction in long-term interest rates made long-duration assets like biopharma and software stocks relatively more attractive.

The Russell 2000 Growth Index obviously has many more biopharma and software stocks than the Value Index. Conversely, the move in rates was not helpful for banks, which constitute a large chunk of the Value Index. In addition, Real Estate and Energy, sectors which have lagged in 2020, are also larger components of the Value Index. With the Federal Reserve's commitment to keep rates lower for longer, it's certainly possible that the relative fortunes of growth and value stocks may not change for quite some time.

What are the biggest risks facing small cap growth stocks right now? What are you doing to manage these risks?

Mr. Craigen: In 2020, I don't think anyone can say the word "risk" and not immediately think "virus." There are plenty of things to be concerned about: the U.S. election, the outperformance of unprofitable companies, and a lack of market breadth, to name a few, but the pandemic remains front and center. Every day brings a greater understanding of the threat posed by COVID-19 as well as progress on vaccines and therapeutics.

That said, there is still a lot about this pandemic that remains unknown. Most immediately, what is the likelihood of a second wave and all the implications that would come with it? A second wave is a very real risk, and some would argue a very likely risk. One of the challenges of thinking through the risks of a second wave is what the reaction will be from investors. Will they punish stocks in line with the turn in fundamentals or will they look through it, even if the economic repercussions are severe? Will more government stimulus - fiscal, monetary, or both - materialize to help bridge the gap?

Our approach to addressing these questions fits squarely with our long-term approach to investing. We know that at some point we're going to come out of this pandemic and the world will look different in some ways, but in many ways it will look very similar. That's the reason why we still have exposure to areas like elective medical procedures, restaurants, and aerospace. We do not have particularly large bets in these areas, mind you, but there are some good franchises in these categories that we believe will thrive again once we come out of this and we want to be there when they do.

How have you repositioned your portfolio in light of the global pandemic, e.g., have you increased your exposure to Health Care or other sectors?

Mr. Craigen: When looking for companies to invest in, we like it when a management team understands what the organization does well and is committed to playing to that strength. We practice what we preach in that regard as we recognize that what we do well is bottom-up stock selection. We don't try to time the market or make sector bets. Our focus is always on trying to find really good businesses, run by really good managers, and investing in them at reasonable valuations.

I think that's important to understand as a backdrop when I say that our most significant response during the market downturn was taking advantage of the pull back to put incremental cash to work in attractive companies that had sold off. Our cash position is never very large. Our mandate is to keep it under 5% at all times, but we started the selloff with cash near the upper end of

the bound and then worked that down considerably as stocks sold off.

During the downturn, we also made some changes to the portfolio that were pandemic specific, such as reducing our aerospace exposure and increasing our vaccine exposure, but these exposure changes were fairly modest as we wanted to play to our strength as bottom-up stock pickers rather than making calls on the economy or the path of the virus.

Can you provide us with an example of a recent stock that you liked and the reasons why?

Mr. Craigen: A good example is Medidata Solutions, Inc., a company we owned for many years. As I've mentioned, the first item on our list of priorities is management. Medidata's CEO was a founder, as was the COO, and both retained significant ownership of the firm. A number of our companies are founder-led as we find that they are more likely to take a long-term view of the company, just as we do. We also like to see a lot of insider ownership. The best way that management teams can align their interests with ours is to have a meaningful stake in the company right alongside us.

As for the business, Medidata had a very strong competitive position as one of the top players in electronic data capture. Their software replaced what was often a manual, paper-based process of collecting patient data during clinical trials for new drugs. The market was underpenetrated and Medidata was well positioned to capitalize on the opportunity. When we initially invested in 2012, Medidata's primary competitor had recently been acquired by a much larger organization that did not have a focus on healthcare. That change in ownership helped open the door for Medidata to take share. The result was both good growth and profitability for a number of years. Ultimately, Medidata was acquired in 2019 for a nice takeout premium.

We have had a number of companies over the years get bought out by either strategic buyers or financial sponsors. M&A is never the core driver of any of our investments, but it is something that we consider in our decision making. When you try to invest in differentiated, well-run businesses, they often attract attention from acquirers.

How large a role does third-party or sell-side research play in your investment decisions?

Mr. Craigen: I like to think that one of the hallmarks of our approach is a lack of hubris. That manifests itself in many ways, one of which is a willingness to engage with people who have a range of opinions, including those on the sell-side. We are always willing to listen to new ideas and differing viewpoints. Having said that, ultimately the contribution from the sell-side is fairly modest. Our investment decisions are really driven by our own research and due diligence.

Do you expect that to change given the spread of COVID-19 and what does that mean given current travel restrictions in many areas of the country?

Mr. Craigen: No. We place a premium on assessing corporate management teams. The pandemic has obviously prevented in-person interactions. However, there have been a few beneficial offsets. Surprisingly, we have had just as many interactions with management teams, if not more, during the pandemic as time that might previously have been spent traveling can now be spent on actual conversations. Also, most remote interactions are now conducted by video conference rather than just phone conversations. We always prefer a face-to-face meeting rather than a phone call.

What, if any, trends have emerged in the small cap growth space in 2020? Is there anything you find especially exciting?

Mr. Craigen: The most exciting trends that come to mind are not new in 2020, but they've come to the fore this year after receiving a big boost from the pandemic. The move to the cloud, increased adoption of ecommerce, and companies putting more effort into automating their operations are some of the secular trends that have been accelerated by stay at home and work from home. The mega-cap technology stocks seem to get all the press as beneficiaries of these trends, but there are plenty of smaller companies that are benefiting as well.

These are themes that we've been focused on for many years and we have a lot of stocks that are riding these trends. These secular forces have played an important role in our portfolio for some time and I expect that will continue to be the case as these trends should continue to be in place for many more years to come.

Second quarter earnings results for small caps came in better than expected overall. What do you anticipate for Q3 earnings?

Mr. Craigen: Second quarter earnings beats were a function of 1) many companies pulling guidance coming out of Q1 and analysts taking down estimates dramatically; and 2) the economy bouncing back. The set up for Q3 earnings isn't quite as good as a number of companies reinstituted guidance coming out of Q2 results, and the pace of the economic recovery has moderated. However, we think it's likely that management teams were a little

conservative on guidance given the still uncertain state of the world, and the economic recovery is continuing, albeit at a less torrid rate. The net of that is that the set up for Q3 earnings beats looks pretty good, just not as good as last quarter.

How do you think the presidential election will impact small caps? Should investors favor certain sectors over others depending on the outcome of the election?

Mr. Craigen: The presidential election gets a lot of air time in the financial media, but control of the White House in and of itself probably doesn't warrant quite as much attention as it gets from a purely investment standpoint. Obviously, there will be some very large differences in policy and regulatory enforcement under a Trump versus a Biden presidency, just as there were in the transition from the Obama administration. But I think it's noteworthy that of all of the small cap growth companies that we have talked to over the years, there were not many that commented that the last change in administration was a needle mover - positively or negatively - from a regulatory standpoint.

Our view is that what is really relevant about the upcoming election is whether the White House, the Senate, and the House are all controlled by the same party. Unified control of government is necessary to see dramatic changes in policy, most notably tax policy, which will impact large swaths of the economy and the market. As for the impact on specific segments of the market, for instance, defense and healthcare, a lot of the details about policy changes in a Biden presidency are not completely clear at this point.

Disclosures

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