

## U.S. Small Cap Growth Strategy

Representative Commentary — 2Q22

Performance	Annualized					
	2Q22	1YR	3YR	5YR	7YR	10YR
U.S. Small Cap Growth Composite (Gross)	-21.15%	-30.60%	1.11%	7.21%	6.69%	10.73%
U.S. Small Cap Growth Composite (Net)	-21.32%	-31.26%	0.13%	6.17%	5.64%	9.65%
Russell 2000® Growth Index	-19.25%	-33.43%	1.40%	4.80%	4.96%	9.29%

*Please see the important performance and other related disclosures at the end of this Commentary, which are an integral part of this quarterly Commentary Newsletter.*

In the second quarter, the “I”’s had it: Interest rates and Inflation commanded the attention of the global markets. Central banks accelerated the pace of their quantitative tightening measures, though inflation stubbornly refused to slacken. Heightened levels of interest rates and inflation punished the equity markets with double-digit negative returns for the quarter, with the U.S. hit the hardest at -17% for the Russell 3000 Index of U.S. stocks, -15% for the developed non-U.S. MSCI EAFE Index, and “only” down -11% for the MSCI Emerging Markets Index. The U.S. Federal Reserve increased rates twice during the quarter, including the largest single increase (75 basis points) since 1994. The subsequent statement indicated that the current range of 1.50% to 1.75% may be double that by the year’s end. The European Central Bank noted it will raise rates from 0% by 25 basis points at its July meeting and again in September—its first increase since 2011. The Bank of England raised its rates for the fifth consecutive time, albeit at a slower pace of 25 basis points, though indicated that its tempo may increase. Many other banks followed suit including even the Swiss National Bank, though its first increase since 2007 lifted rates from -0.75% to -0.25%. Japan was the lone holdout among the major money centers to maintain its accommodative monetary policies. While commodity and energy prices eased late in the quarter, they remained at elevated level compared with earlier in the year. Global supply chains remained stretched, demand was subdued, and business optimism waned so that were it not for a rebound in China after recent COVID lockdowns were eased, growth in global business activities would have slowed for a third straight month.

Specific to the U.S., the mixture of high inflation, rising interest rates, and a tight labor market fueled concerns for a coming recession. In addition to weighing on business optimism, that combination—though especially inflation—pushed consumer sentiment down to its lowest level since the measure began in 1952. One result was the continued relative outperformance of value stocks over growth and relatively better returns when moving up the size continuum from microcaps to megacaps. Within U.S. small and mid cap growth stocks, the safer havens were in the Consumer Staples, Utilities, Energy, and Materials sectors whereas the Information Technology, Communication Services, and Consumer Discretionary areas were shunned. Stocks with higher quality and lower risk were favored, while those with high valuations or lacking earnings were especially punished.

Amidst this environment, the strategy underperformed the Russell 2000® Growth Index for the quarter. Strength in the Information Technology and Real Estate sectors was offset by relative weakness in Consumer Discretionary, Financials, Health Care, and Industrials.

Within Consumer Discretionary, **National Vision Holdings Inc.** is a specialty retailer of optical products operating under the America’s Best and Eyeglass World brands. Its shares fell -37% after the company reported mixed first quarter results as earnings outpaced estimates while revenues fell short. A lack of available optometrists constrained vision exam capacity and forward guidance was cut due to recent trends. National Vision raised the

price of its signature offering by 15% for an eye exam and two pairs of glasses, given the broader inflationary environment. **Leslie's Inc.**, the world's largest omnichannel retailer of swimming pool products and services, sank -22%. Fiscal second quarter sales were above the consensus, however, higher operating expenses caused profits to only be in line. Management left second half guidance unchanged. With approximately 80% of sales tied to maintenance, Leslie's sales have been resilient through multiple housing and rising interest rate periods. Chemical prices are forecasted to remain elevated, given the shortage of chlorine. We added to the position on weakness. **Hilton Grand Vacations Inc.** is a timeshare company that sells vacation ownership intervals and manages resort properties. Their stock lost -31% despite reporting a beat and raise quarter amid a backdrop of increased travel demand. The Diamond Resorts acquisition appears to be integrating ahead of schedule, with cost synergies yet to be realized. The Board approved a \$500 million share buyback program over the next two years. **PowerSchool Holdings Inc.** provides cloud-based software serving the K-12 education market. They reported solid first quarter results and increased forward guidance, which included 300 cross-sell transactions and multiproduct deployments by two private school groups in the United Arab Emirates. Management noted a very healthy pipeline heading into the peak selling season. Fundamentals remain solid in the K-12 industry. The seasonal aspect to their business can lead to ebbs and flows causing the industry being in and out of favor, causing the stock to retreat by -27%. **Driven Brands Holdings Inc.**, a provider of automotive services to retail and commercial customers, gained 5%. First quarter results were solid, and the company reiterated full year guidance. Driven increased its market share across all segments on both higher car counts and rising average ticket. The company has not detected any material impact on consumer demand from rising gasoline prices. We added to the position on weakness. **Malibu Boats Inc.** manufactures recreational powerboats under brands such as Cobalt, Pursuit, Maverick, and Cobia brands. Malibu continues to navigate supply chain challenges as unit volumes drove the upside in their latest quarter. Retail demand remains solid, and they are not seeing any order cancellations. Its -9% share price decline represented outperformance versus the index sector average of -21%. **Visteon Corp.** also outperformed with their -5% return. The automotive electronics supplier reported blowout first quarter results against low expectations. The company launched 16 new products during the quarter. Semiconductor shortages impacted the infotainment product line and Visteon continues to redesign a number of products using alternative semiconductor chipsets. The move to digital dashboards is accelerating, with most of new business wins coming from these types of advanced clusters or displays.

The largest detractor this quarter came from the Financials sector. **Silvergate Capital Corp.** offers banking and loans

as well as ancillary services for users of cryptocurrencies. The stock felt the impact of cryptocurrency volatility with its shares tumbling by -65%. U.S. regulators want to bring crypto into the banking system and avoid the potential for systemic risk. Treasury Secretary Yellen has urged Congress to pass legislation for the regulation of stable coins. **BTRS Holdings Inc.** provides cloud-based software and integrated payment processing solutions that simplify and automate business-to-business commerce. They reported a solid quarter and maintained its full year guidance, though inclusive of loss expectations. The key to our thesis is their subscription and payment revenue, which have grown substantially. New partnerships were announced with American Express, Coupa, and KeyBank. The market appears to have no patience with this type of business in these market conditions as the stock sold off by -33%. **Evercore Inc.** operates as an independent investment banking advisory firm. First quarter earnings and revenues were above consensus estimates. Management was constructive on its business outlook despite a more challenging and uncertain macroeconomic environment. While the stock slipped by -15%, that was above the index sector average return of -19%. Another relative outperformer was **Hamilton Lane Inc.** with its -13% return. This company offers private markets investment solutions. Hamilton Lane designs investment portfolios across private equity, infrastructure, private debt, real estate, natural resources, and venture capital utilizing strategies with third-party fund managers. Earnings for the latest quarter beat Street estimates, aided by fee-related earnings as assets under management impressively climbed beyond the \$100 billion level for the first time in the company's history. We added to our position during the quarter.

In Health Care, **Outset Medical Inc.** supplies dialysis solutions to patients and healthcare providers. Sales for the latest quarter were ahead of the consensus. On the hospital side, they had new sales agreements and an expansion of sales with existing customers. During the quarter, Medtronic and DaVita announced plans to launch a kidney care company whose portfolio will include future home-based products. It does appear this news was the cause of its -67% decline. While we do not view this offering as a competitive threat to Outset Medical's Tablo. We reduced our Outset Medical position on news the FDA temporarily halted shipments and requested more human factors studies on the Tablo device after the company made minor modifications. **Tandem Diabetes Care Inc.**, a medical device company that designs and develops products for people with insulin-dependent diabetes, was driven down by -49%. Strong first quarter results stemmed from higher U.S. sales. Management increased full-year sales guidance. Profits were below expectations as the company spent aggressively on new product development. The company expects to file for approval of its Mobi pump during the third quarter. **AtriCure Inc.** develops and manufactures devices designed for the surgical ablation of

cardiac tissue. A mixed first quarter resulted in a -38% fall. That included beats to revenue and profit estimates while earnings fell short. Management cited momentum building among physicians for their products, particularly minimally invasive and pain management. The company is still in the early stages of various product launches and continues to make investments across sales and training teams. **Inspire Medical Systems Inc.** is focused on the development and commercialization of minimally invasive solutions for patients with obstructive sleep apnea. Their stock lost -29% although revenues exceeded projections in the latest quarter and forward guidance was raised as center activation continues at a rapid pace. **Phreesia Inc.**, a supplier of an integrated software and payment platform for the healthcare industry, slid by -5%. That represented outperformance against the index sector average return of -19%. The company reported solid results, inclusive of a modest revenue beat and improved profits. Management noted operational efficiencies from a new enterprise resource planning system. **Certara Inc.** is a provider of software products and technology-enabled services for drug discovery, clinical research, and regulatory submissions. First quarter earnings were in line with estimates, with better revenues offset by higher costs in areas such as research, hiring, and legal fees. Management has not seen any signs of customer pullback or cancellations caused by a weaker biotech funding environment. New business bookings activity was robust. It shares were flat for the quarter and we added to the position. **PTC Therapeutics Inc.**, a biopharmaceutical company focused on the discovery and development of medicines for patients with rare disorders, rose 7%. First quarter revenues were ahead of the Street, highlighted by its Duchenne Muscular Dystrophy therapeutics.

Within Industrials, the share price of professional staffing company **ASGN Inc.** pulled back by -23%. Its business is focused on technology, digital, creative, engineering, and life sciences fields. The company's revenues, profits, and earnings were all ahead of sell-side estimates in the latest quarter. Management's forward guidance is predicated on above-market growth and gross margin expansion. Large enterprise clients have raised spending in areas such as digital transformation and workforce mobilization. In June, they announced the acquisition of GlideFast, a provider of tailored consulting services. We decided to trim the position. **ACV Auctions Inc.** offers a mobile auction platform that enables wholesale traders to sell trade-in vehicles. A mixed first quarter resulted in a -56% retreat. Despite seeing revenues ahead of Street expectations, the company reported a loss due to dealer incentives and arbitration costs. Management expects these costs to moderate throughout the year. **The AZEK Company Inc.** designs and manufactures wood alternative building products. They continue to deliver very strong revenues, with both its residential and commercial businesses posting impressive growth rates. Despite these positives, the stock trade down by -33% on housing market fears and

commodity price inflationary pressures. **Casella Waste Systems Inc.** operates as a vertically integrated solid waste services company operating in the northeastern U.S. Their services include waste collection, transfer disposal, and recycling services to a broad customer base. Revenues for the first quarter surpassed Street estimates on better solid waste pricing, though volumes were a bit lower than anticipated. The waste industry continues to consolidate, exemplified by Casella closing six deals thus far in 2022. Despite these positives, the stock fell -17% for the quarter. **Sun Country Airlines Holdings Inc.** is an air carrier offering scheduled passenger, air cargo, and charter transportation services. It shares descended -30% even though they reported upside to sell-side estimates from higher scheduled service revenues. In addition, the company raised fares to offset increased fuel costs, while its charter and cargo operations include fuel pass-through agreements. Better relative performance was found in engineered precision bearings manufacturer **RBC Bearings Inc.** and its -5% return that outpaced the -17% benchmark sector average return. The company reported solid fiscal fourth quarter results, outpacing estimates for revenues and earnings. There was notable sales growth in the Aerospace and Industrial segments. The acquisition of Dodge more than doubled its exposure to the industrial market, with the integration tracking ahead of schedule. **Sterling Check Corp.** is a provider of technology-enabled background and identity verification and employment screening services. We decided to sell out of the position due to a projected hiring slowdown. Sterling slid by -5% for the time it was held in the quarter. New to the portfolio this quarter is **Chart Industries Inc.**, a manufacturer of engineered equipment for the energy and industrial gas industries. They are experiencing accelerated equipment demand across its customer base, which includes liquefied natural gas, traditional energy, hydrogen, and other specialty markets.

Mergers and acquisition activity has started to pick up. Case in point was private equity group Thoma Bravo announcing they were buying **SailPoint Technologies Holdings Inc.**, a provider of enterprise identity security solutions. We trimmed the position as it approached the take-out price and booked a 22% gain. **EVO Payments Inc.**, a supplier of payments technology and services, edged forward by 2%. The company reported a solid quarter with metrics above expectations. They saw a jump in revenues from Poland, with an influx of refugees from Ukraine. **ExlService Holdings Inc.** is an operations management and analytics company. They reported strong first quarter results with revenues and earnings exceeding expectations. Drivers of the upside included strong performance in the analytics segment and digital transformation engagements. During the quarter, ExlService signed 19 new customers. Updated forward guidance includes higher wages for Philippines' based workers as well as for roles in the analytics area. These developments lifted the stock by 3%. Moving in the

opposite direction was **Workiva Inc.**, a cloud-based compliance and regulatory reporting solutions provider, dropped -44%. While its first quarter had a slight beat to Street estimates, second quarter guidance was below. Weakness in its Capital Markets and SEC reporting business was offset by strength in Global Risk & Compliance. **Synaptics Inc.**, a developer of human interface semiconductor solutions for electronic devices, retrenched by -41%. Fiscal third quarter results were ahead of the consensus as Internet of Things overcame weakness in smartphones and personal computers.

In other trading across sectors, an addition to the Real Estate sector this quarter was **National Storage Affiliates Trust**, which is focused on the ownership and operation of self-storage properties. Demand has been strong, leading to a 95% occupancy rate. The main source of weakness for the Energy sector was our underweight relative to the benchmark. We added **Cactus Inc.**, a provider of U.S. onshore wellhead and pressure control equipment. The company sells wellheads and production trees. They also rent out frac equipment that is used during well completions. Cactus continues to take share from competitors given its differentiated product offering. In Utilities, the portfolio's sole holding was **Sunnova Energy International Inc.**, a provider of solar energy systems to residential customers. We decided to exit the position in consideration of the increased pressure from adverse regulation and higher financing costs. Sunnova tumbled -29% for the time we held the position during the quarter.

One of our strategy's purchase rules is based on the range of market capitalizations in the Russell 2000 Growth Index following its annual reconstitution. After the reconstitution at quarter end, the largest stock in the index had a market capitalization of \$6.8 billion (after excluding an outlier well above that). The strategy's guideline limits new positions outside the benchmark at the time of initial purchase to less than 75% of the largest name in the benchmark—or \$5.1 billion based on the new benchmark—so we will move our limit to \$5.0 billion from the current level of \$6.0 billion. The lower end of the purchase range moves from a market capitalization of \$31 million to \$10 million, which matches the smallest stock in the benchmark.

Looking into the summer and beyond, it remains to be seen if policy makers can engineer the proverbial “soft landing” that combats the global inflationary environment without triggering a recession. That may be possible, though its runway has been narrowing. Companies have been very tempered with their projections, though there have been few corresponding reductions to their consensus earnings estimates. So, while we see pockets of opportunities with lower prices, we recognize that further dips are possible. These concerns form some of the backdrop for our discussions with company management teams. That factors into our bottom-up evaluations as we seek a balance of positions that can weather oncoming waves along with those poised to gain when the winds change. As always, we are available for any questions you might have as we endeavor to protect the assets you have entrusted with us.

## **General Disclosure:**

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## **Composite & Performance Disclosure:**

*Performance is measured against the Russell 2000® Growth – a market capitalization-weighted index that measures the performance of those Russell 2000® companies with higher price-to-book ratios and higher forecasted growth rates. All indexes, including the Russell 2000® Growth Index, are based on gross-of-fee returns. Russell Investment Group is the source and owner of the Russell Index data contained or reflected in this material and all trademarks and copyrights related thereto.*

*This composite invests in stocks with market capitalizations generally between \$91 million and \$3.5 billion at time of purchase. The process is fundamental research driven. The investment style is growth. Portfolios will hold approximately 90-120 stocks. Historical turnover has averaged 53% per year. Composite inclusion threshold \$5mm. Fee basis is 100 basis points. The composite creation date is October 1, 2000.*

*Effective 04/01/2015, TimesSquare removes accounts from this composite when significant cash flows occur. A significant cash flow is defined as an external flow that exceeds 10% of the composite's market value on the day of the cash flow. Effective 01/01/2017, the significant cash flow policy has been removed.*

*In July 2014, TimesSquare modified its purchase capitalization range to match the changes in the small cap market as represented by the Russell 2000® Growth Index. The purchase range was amended to reflect a range bounded by the approximate value of the smallest security in the index (in most cases) and the approximate value of 75% of the largest security's capitalization. These targets will be maintained for the subsequent 12 months, and may be adjusted based on the above rules each July following the reconstitution. In that manner, the targets would be responsive to higher or lower capitalization profiles of the indexes over time. Previously, in June 2012, TimesSquare had modified its purchase capitalization range to match the changes in the small cap market as represented by the Russell 2000® Growth Index at that time, with a change from \$50 million to \$1.5 billion at time of purchase to \$50 million to \$2 billion.*

*The performance figures shown are calculated in U.S. dollars on a size-weighted basis and reflect the reinvestment of dividends and other earnings, and the deduction of brokerage commissions and other transaction costs. Performance is provided on a gross basis (before the deduction of management fees) as well as net of the highest management fee of 1.00% charged by TimesSquare to separately managed institutional accounts in this composite. Investment advisory fees generally charged by TimesSquare are described in Part 2A of its Form ADV. This composite may contain some accounts that have used performance based fees. To illustrate performance net of fees, assume \$20,000,000 is placed under management for ten years sustaining 10% compound gross total return. If an advisory fee of 1.00% of average assets under management is charged per year, for each year of the ten-year period, the resulting compound annual return would be reduced to 9.0%. The ending dollar value of the account would be \$47,347,274 compared with the unreduced account value of \$51,874,849.*