TimesSquare Capital Management, LLC

# U.S. Small/Mid Cap Growth Strategy

**Representative Commentary — 3Q22**

## Performance

| | | | Annualized | | | |
|---|---|---|---|---|---|---|
| | **3Q22** | **1YR** | **3YR** | **5YR** | **7YR** | **10YR** |
| U.S. SMID Cap Growth Composite (Gross) | 0.47% | -28.08% | 4.05% | 6.66% | 8.02% | 9.60% |
| U.S. SMID Cap Growth Composite (Net) | 0.22% | -28.81% | 3.02% | 5.60% | 6.95% | 8.52% |
| Russell 2500™ Growth Index | -0.12% | -29.39% | 4.75% | 6.30% | 8.83% | 10.30% |

***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.***

Global markets—using the MSCI World Index as a proxy—began the third quarter in fine fashion (up 8% in July) but stumbled (down -4% in August) and then fell further (-9% in September). For the full quarter, the greatest discomfort was in emerging markets with a -12% return, followed by relative improvements in developed non-U.S. markets with its -9% showing, and -4% for the U.S. Measures of global economic activities fell to the demarcation line between expansion and contraction—with manufacturing showing greater weakness than services though both noting slower rates of new orders. That ebbing tide contributed to falling prices among commodities, especially oil and natural gas.

Central banks commanded investor focus during the quarter as they continued constricting their respective monetary supplies. Setting the pace, the U.S. Federal Reserve increased rates twice during the third quarter at 75-basis-point increments to a new range of 3.00% to 3.25%. There also were a pair of hikes from the European Central Bank, which made its first increase since 2011 in July and followed that with another in September, swinging European interest rates from negative territory to the current 0.75%. Other money centers shadowing those moves included Switzerland, which lifted its interest rates above 0% for the first time since 2014. The one notable holdout remained Japan, which was steadfast in maintaining its negative interest rate policy, though the Bank of Japan bought yen for the first time in over 20 years to buoy its falling currency. Currency woes also knocked the U.K. late in the quarter—bringing its pound to all-time lows vs. the U.S. dollar—as new Prime Minister Truss unveiled an economic stimulus plan that included significant tax cuts (in response to the market reaction, that portion of the plan was withdrawn). Despite all those actions, global inflation rates remained at elevated levels.

Across the U.S. equity landscape, investors backed either prior winners or potential hyper-growth areas. On the surface, the Russell value indexes were punished more than growth and there were steadily worsening returns as size increased (from the microcap to the megacap indexes). Underlying that, the influence of the growth style was neutral while value was negative; stocks with high exposures to market sensitivity or momentum reaped relative benefits. Among small and mid cap growth stocks, there were positive returns for stocks with high valuations and higher growth rates for sales. Despite falling commodity prices, the Energy sector remained relatively strong while Real Estate and Consumer Staples especially lagged. Also notable was that Health Care had positive returns for small caps, led by the Biotechnology industry, but both were below average in mid cap, where stocks in that industry and sector tend to be more mature in their growth profiles.

During the third quarter, the portfolio outperformed the Russell 2500™ Growth Index. There was weakness in the Financials, Health Care, and Industrial sectors that was more than offset by strength in the Consumer Staples, Consumer Discretionary, and Information Technology sectors.

A gyrating market led to price retrenchments among our Financials sector holdings this quarter. That caused an -11% retreat in the shares of **Hamilton Lane**, which provides private markets investment services. There were some market concerns about the challenging distribution environment for private equity firms seeking to monetize their investments, even though that type of activity was not a material influence on Hamilton Lane's services. Though some investors viewed Hamilton Lane through the same evaluation lens as publicly traded private equity firms, its business is significantly different.

The Health Care sector provided no balm to our performance in the third quarter. One area of pain was **Catalent Inc**, which was the strategy's greatest detractor. A provider of delivery technologies and development solutions for a variety of medical health products, Catalent's revenues were less than expected, though the culprit was unfavorable foreign exchange translations. Of greater concern to the market was the lower-than-expected guidance for the new fiscal year, which removed any potential COVID-related activity that had not already been contracted. Despite that absence, we believe Catalent has a favorable growth profile for the next year, though this quarter the market deducted -32% from its share price. Slipping by -18% was **Intra-Cellular Therapies**, which develops small molecule treatments for neurological disorders. The company reported revenues that were better than expected, though earnings were lower. There was an acceleration of sales for Caplyta, a treatment for schizophrenia and bipolar depression. However, some investors appeared concerned that as Caplyta volumes increased to a higher level that optically the rate of growth will slow. We view the projected growth trajectory positively, as well as Caplyta's potential for use in other indications. **Silk Road Medical** contributed a 24% gain this quarter. Its revenues outpaced estimates on higher procedure volumes using Silk's innovative treatments for carotid artery diseases, particularly transcarotid artery revascularization (TCAR). Later in the quarter at an industry conference, Silk's management was optimistic about the recently increased reimbursement coverage for TCAR and its potential for greater use. Elsewhere, we exited our position in **Outset Medical**, a developer of a self-contained, low-cost dialysis machine. Late in the second quarter, we reduced our holdings following the news the FDA temporarily halted shipments and requested more human factors studies on its Tablo device for home use after the company made minor modifications to it. This quarter, the FDA reversed course and allowed Outset to resume sales of Tablo. Outset subsequently reissued its guidance, though expected lower growth rates while it rebuilt the sales group for home sales, and hospitals tightened their capital budgets. That led us to sell our remaining holdings.

There were also challenges from the Industrials sector. One example was the -24% slip from the global welding company, **ESAB Corporation.** While ESAB's revenues and earnings were better than expected, the guidance for the balance of the year was lower. A spinoff from a larger company in the spring (when we initiated our position), ESAB has a limited sellside following and recently began excluding its Russian operations from its reporting, which can cause short-term price volatility. However, ESAB successfully increased prices for its welding equipment and sees opportunities in Europe and the emerging markets. We continued to build our position during this quarter's price weakness. Offsetting that somewhat was the 12% return posted by **EMCOR Group**, which provides construction and operational services for mechanical and electrical systems to a broad range of commercial, industrial, utility, and institutional customers. As an industrial company well-positioned to pass along higher costs and maintaining its margins, EMCOR reported higher-than-anticipated revenues and earnings, increased guidance for the balance of the year, and authorized an additional $500 million share repurchase plan. There was a healthy backlog of orders for refinery services, building retrofits, construction, and advanced industrial areas. New to the strategy this quarter was **Generac Holdings.** We own Generac in our Mid Cap Growth strategy, and the late-quarter price pullback provided an opportunity to add a position in Small/Mid Cap Growth for this designer and manufacturer of power generator products for residential, commercial, and industrial markets.

The Consumer Staples sector also contributed to the strategy. That included the 17% gain from **BJ's Wholesale Club**, a warehouse club operator focused on smaller package sizes for clients that tend to live in cities or smaller homes. BJ's reported revenues and earnings that outpaced expectations. Though inflation weighed on margins in some areas, the size of BJ's membership grew as did the corresponding fee income. Much as it did in the early days of the pandemic, BJ's demonstrated meaningful value to its membership during the current inflationary period.

The strategy was aided by the Consumer Discretionary sector as well. Here there was a 38% gain from **PowerSchool Holdings**, a cloud-based platform and collaboration software for K-12 educational settings. After reporting revenues and earnings that were higher than anticipated, PowerSchool increased its guidance for the rest of 2022. The company cited sales growth across all its end markets and benefited from sales of additional services to existing clients. Working against that was a -15% decline from **Planet Fitness**, which franchises fitness centers across the U.S. Planet Fitness reported revenues and earnings that were less than anticipated. Activities at the centers were stable, though equipment sales declined—mostly from a lack of supply from Chinese manufacturers. In addition, some marketing expenses temporarily increased, which pinched margins. We believe that both of those influences should wane; meanwhile the company's core business was growing steadily. Seeing a brighter result was **National Vision**, a value-oriented optical retail chain providing eye exams, eyeglasses, and contact lenses. The company's revenues and earnings exceeded expectations as initial back-to-school activities were beneficial. National Vision also repurchased 2.6 million shares and the net result was a 19% share price climb.

A final area of strength was the Information Technology sector. This was home to the strategy's greatest contributor, **Paylocity Holding**—the provider of cloud-based payroll and human capital management software for medium-sized organizations. Paylocity reported better-than-anticipated revenues and earnings, along with higher initial guidance for its new fiscal year than investors expected. Employee volumes at Paylocity's existing clients increased, as did the size of new clients recently gained. That led to a 38% gain for its shares. Offsetting that somewhat was the -28% showing from **Integral Ad Science,** which provides digital advertising verification services. Although revenues and earnings met expectations, management reduced its guidance for the rest of the year. Weakness from a potential recessionary environment may delay starting recent deals or otherwise elongate the sales cycle. We expect Integral to continue its strong growth path with healthy margins, so we added to our holdings. More beneficial was **Monolithic Power Systems**, which designs, develops, and markets high-performance power management semiconductors. Mid-quarter the company reported revenues and earnings that far outpaced expectations, as did its guidance for the next quarter. Monolithic increased its market share, introduced new products that were well received, and improved its margins. The only downside was that Monolithic's size grew past the range for the strategy, so we sold our holdings as they gained 37% while we owned it during the quarter. An acquisition target this quarter was **EVO Payments**. This international merchant acquirer & payment software provider agreed to be acquired by a larger firm in that industry, and its shares rose by 41% and we exited our position. Similarly, we left behind our holdings in **Avalara Inc**., an outsourced provider of end-to-end tax compliance services for small to mid-sized businesses. In this instance, a private equity fund announced its intention to acquire Avalara. New to the strategy was **Onto Innovation**, which develops inspection technologies for use across the entire semiconductor fabrication process. Though other companies in the fabrication industry reported lower results or cited weak market conditions, Onto's fundamentals were relatively unaffected. Sales for its process control systems were a function of transitions to new technologies and the construction of new facilities—both of which were increasing—and not merely overall semiconductor capacities. Nevertheless, Onto's shares pulled back mid-quarter, which made an attractive entry point for us.

Surveying the remainder of 2022, there seem to be many uncertain balances ready to tip either way. With nearly all central banks well on the quantitative tightening path, there are concerns whether they might raise rates too high too fast, as well as worries that they may pivot and begin easing too soon. Many economies across the globe teeter on the edge between expansion and contraction with the determining factor appearing to be new order demand, which has not yet fully recovered. Across our investment universe, companies are concerned about a future recession, and many have taken precautionary steps for a more challenging future business environment. Our bottom-up analysis and discussions with company management teams aim to find holdings that can be resilient whichever way the scales tilt. 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:***

*The holdings discussed represent a particular point in time. It should not be assumed that the securities continue to be held, and/or continue to be held in the same percentage, and/or were held continuously throughout the period. In addition, the holdings of a particular client account may differ from the information provided. Securities discussed do not represent the entire portfolio and, in aggregate, may represent only a small percentage of a portfolio's holdings. Information is subject to change without notice. It should not be assumed that any of the securities discussed were or will prove to be profitable. Past performance does not guarantee future results.*

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***Firm and Composite Information***

*TimesSquare Capital Management, LLC ("TimesSquare") is a registered investment adviser that is owned by the former equity management team of TimesSquare Capital Management, Inc. ("TimesSquare Inc.") and Affiliated Managers Group, Inc. TimesSquare was formed to manage TimesSquare Inc.'s growth equity investment advisory business which was sold to TimesSquare in a transaction that closed on November 19, 2004.*

*This composite invests in stocks with market capitalizations at time of purchase generally within the range of capitalizations of stocks in the Russell 2500 Growth Index. The process is fundamental research driven. The investment style is growth. Primary selection criteria include quality management, distinct competitive advantage, and strong, sustainable growth. Portfolios will hold approximately 90-120 stocks. Historical turnover has averaged 61% per year. Composite inclusion threshold $5mm. Fee basis is 100 basis points. The composite creation and inception date is November 1, 2000.*

*From 04/01/2015 until 12/31/16, accounts are removed from the composites 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 January 1, 2017 this composite does not have a significant cash flow policy.*

*In July 2014, TimesSquare modified its purchase capitalization range to match the changes in the small/mid cap market as represented by the Russell 2500™ Growth Index. The purchase range was amended to reflect a range bounded by $300 million 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.*

*The opinions and information expressed and provided are for general information only and are not intended to provide specific advice or recommendations but rather, a basis from which strategies can be built, taking into account the specific objectives of each portfolio, in terms of return, time horizon, and risk constraints, as well as diverging investment perspectives and assumptions. All material has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed.*

*TimesSquare's list of composites is available upon request. Past performance does not guarantee future results. The firm's list of limited distributed pooled funds are available upon request.*

***Benchmark***

*Performance is measured against the Russell 2500™ Growth – a market capitalization-weighted index that measures the performance of those Russell 2500™ companies with higher price-to-book ratios and higher forecasted growth rates. All indexes, including the Russell 2500™ Growth Index, are based on gross-of-fee returns. FTSE Russell is the source and owner of the Russell Index data contained or reflected in this material and all trademarks and copyrights related thereto.*
*Benchmark returns are not covered by the report of independent verifiers.*

***Performance Calculations***

*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 fee level from the standard fee schedule listed for this strategy during the period presented 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.*

*Internal dispersion is calculated using the equal-weighted standard deviation of all accounts included in the composite on a gross basis for the entire year; it is not presented for periods less than one year or when there were five or fewer portfolios in the composite for the entire year.*

*The three-year annualized standard deviation measures the variability of the composite and the benchmark returns on a gross basis over the preceding 36-month period. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.*

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