TIMESSQUARE
CAPITAL MANAGEMENT, LLC

# U.S. Small/Mid Cap Growth Strategy

**Representative Commentary — 4Q22**

**Performance**

| | | | Annualized | | | |
|---|---|---|---|---|---|---|
| | **4Q22** | **1YR** | **3YR** | **5YR** | **7YR** | **10YR** |
| U.S. SMID Cap Growth Composite (Gross) | 6.03% | -25.06% | 3.46% | 6.45% | 8.65% | 9.85% |
| U.S. SMID Cap Growth Composite (Net) | 5.77% | -25.82% | 2.43% | 5.40% | 7.58% | 8.77% |
| Russell 2500™ Growth Index | 4.72% | -26.21% | 2.87% | 5.97% | 8.97% | 10.61% |

***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 2022, global equity markets retreated sharply after three consecutive years of double-digit gains. For example, the MSCI World Index declined by -18% after average calendar year gains of 22% from 2019 to 2021. Though there were many economic challenges for the markets last year, weakness among global equities did not arise from poor company fundamentals—realized and projected earnings per share for the average MSCI World stock were either stable or increased in 2022 while their price/earnings ratios contracted. Weighing on the markets during the year was a combination of higher inflation rates, climbing commodity prices, tighter monetary policies, and slowing measures of business activities that moved into the range of economic contraction.

Though down for the year, in the fourth quarter equities rose from troughs earlier in 2022. That initial rebound was strongest for non-U.S. developed markets with a 17% quarterly gain, followed by emerging markets at 10%, and then 7% for the U.S. Across all geographies, value stocks remained favored above growth stocks. Positive returns were more evenly distributed among the global economic sectors this quarter, although for the year Energy remained the lone positive—and significantly so. As inflation rates remained above the goals for most major central banks, many of them raised interest rates at least once during the quarter. The quarter ended on some positive notes as China abandoned its zero-COVID policy and commodity prices began to ebb.

Focusing on the U.S., the year began with highs and lows that moved to opposite ends of their respective spectrums. In January, economic activities were well into the range of expansion, but by year-end they fell into contraction levels. Consumer expectations eroded, in part matching the progressive climb of inflation, though the latter began to recede in the fourth quarter. Perhaps the most notable and steady ascent in 2022 was driven by the Federal Reserve's pace of rate increases—seven raises lifted federal funds from a zero-interest rate policy to a range of 4.25% to 4.50% in December. In the fourth quarter among small-to-mid cap growth stocks, there was a pronounced preference for quality and valuation as stocks with higher returns on equity or lower price/earnings ratios outperformed. Stocks that lacked earnings or were projected to have negative earnings growth were punished.

Amidst this environment, the portfolio outperformed the Russell 2500™ Growth Index in the fourth quarter, leading to its outperformance of the benchmark for the full year. There was relative weakness in the Information Technology and Energy sectors that was more than offset by strength from our positions in the Financials, Consumer Discretionary, Health Care, and Industrials sectors.

Some industry influences in the Information Technology sector weighed on our relative performance, such as the market preference for hardware over software. That included this quarter's greatest detractor, **Paylocity Holding**. A provider of

cloud-based payroll and human capital management software for medium-sized organizations, Paylocity reported revenues, earnings, and forward guidance that were higher than anticipated. The company won new clients, which combined with cross selling and higher employment levels at existing clients added to Paylocity's growth. However, it seemed that Paylocity was caught by negative market sentiment for either employment-related stocks or high growth software, and its shares retreated by -19%. That was counter to our view on its fundamentals, so we added to Paylocity on that weakness. Another weak software firm was **Elastic NV**, which develops enterprise-wide search and analytical services for a diverse set of uses. Although the company reported better-than-expected revenues and earnings, sales growth for its cloud-based offering was less than anticipated. While that led to a -28% punishment for Elastic's shares, its projected growth remains substantial. There was a positive stock reaction to **Allegro MicroSystems**; a semiconductor developer of magnetic sensors and power management chips, which rose by 37%. Allegro reported revenues, earnings, and forward guidance that outpaced expectations as the demand environment remained strong in its automotive and industrial end markets. New to the strategy this quarter is **Flywire Corp**., a global payments platform focused on education, health care, and travel industries. The company operates in targeted vertical markets providing both the payment software and handling cross-border payments. Flywire's management team has met its strategic targets since the company's IPO in 2021 and we believe they are well-positioned to continue growing the business from current operations and future adjacent areas.

The strongest sector during the fourth quarter was Energy. Because we believe many of these companies lack unique competitive aspects, we tend to underweight this sector and that was detrimental to relative returns this quarter. Offsetting that effect somewhat was the 31% gain from **Cactus, Inc**., a provider of onshore wellhead and pressure control equipment for oil drilling. Recent revenues and earnings were better than expected, and Cactus expects that its rig service usage will increase in the coming quarters, as should its margins.

Turning to areas of strength, there were contributions from the Financials sector this quarter. Leading that charge was the 31% gain from the reinsurance provider **RenaissanceRe Holdings**. RenRe's level of gross premiums written was higher than anticipated, though more importantly the company expects that underwriting income, investment income, and fee income all are poised to increase materials in 2023. We trimmed our position on that strength. Diminishing the benefits of this sector was the -23% return from **Signature Bank**. A commercial bank serving businesses and private clients, predominantly in the New York metropolitan area, Signature also holds deposits of cryptocurrencies for clients. Though representing less than 25% of its deposit base and 0% of its lending, the troubles of high-profile cryptocurrencies and their exchanges reverberated throughout that ecosystem and all service providers. Better was the 18% gain from **Focus Financial Partners**, an affiliation of wealth management firms globally. Focus reported revenues and earnings that bested expectations, although management tempered its outlook for the next quarter given the variable nature of performance fees for its underlying firms. Later, Focus improved its capital position when it negotiated a new credit facility so the firm could maintain its leverage targets. With the improving backdrop for insurance companies, we began a position in **Brown & Brown**. An independent insurance broker specializing in property, casualty, employee benefits, personal lines, and ancillary services, we believe that Brown will benefit as insurance pricing broadly increases and the company has consistently higher margins than peers. The recent weakness in its shares provided a particularly attractive opportunity for building our position.

Another bright spot for performance was the Consumer Discretionary sector. This quarter **PowerSchool Holdings** turned in a 38% return, which made it the strategy's greatest contributor. At the start of the quarter, we added to our position in this cloud-based platform and collaboration software provider for K-12 educational settings. Later, the company reported revenues that were in line with expectations and earnings that exceeded them. Customer retention was over 100% during the recent renewal period (meaning on a net basis customers renewed for a higher dollar level of services) and PowerSchool signed new contracts with a major city's school system and an online education provider.

The Health Care sector also benefited the strategy in the fourth quarter. At the top of the chart was **Encompass Health Corporation,** one of the largest U.S. providers of post-acute services, such as rehabilitation. Though many hospitals reported lower levels of inpatient admissions, Encompass reported better-than-expected revenues that were bolstered by its in-patient rehabilitation facilities. While increased labor costs did pinch earnings, Encompass continues to meet its volume demands and is well-positioned for further growth. That sent its shares 33% higher in this quarter. Undercutting that contribution was the poor showing from **Catalent Inc**., which provides delivery technologies and development solutions for a variety of medical health products. Its results came in below consensus expectations as well as our estimates. We decided to exit the position, which was down by -36% while we owned it this quarter. The strategy was

better served by **Legend Biotech**, a biotechnology developer of cell therapies to treat blood cancers such as multiple myeloma and leukemia. Early in the quarter, Legend announced that the preliminary sales rates of Carvykti—co-developed with Johnson & Johnson—were progressing as expected in the U.S. That bodes well for the treatment's launch early next year in Japan and Europe. In the near term, Legend's shares gained 23%. Elsewhere in the sector, we added the biotechnology firm **IVERIC bio**, which is developing new treatments that delay vision loss from retinal diseases. Its Zimura therapy was recently granted "breakthrough" status by the FDA, meaning that the preliminary data showed substantial treatment improvements, and its new drug application is anticipated to be approved in 2023.

A final area of strength was the Industrials sector. At the lead was the global welding company **ESAB Corporation**. Despite a challenging economic environment for its end markets, ESAB reported revenues and earnings that exceeded expectations thanks to growth in volumes and pricing. That growth continued unabated, despite the exclusion of its divested operations in Russia, and lifted its shares by 43%. We continued to build this position—first added to the strategy in the spring—including during its secondary offering in November. Slipping by -13% was **Zurn Elkay Water Solutions**. Zurn specializes in water management products for end markets including commercial, residential, industrial, energy, aerospace, and construction—all of which fared differently recently. The company's revenues were below expectations and earnings were in line, though management offered lower-than-expected guidance for the next quarter. Exposure to residential markets tempered the outlook as did a prior overestimation of near-term sales from the recently acquired Elkay operations. Later, Zurn's management noted there may be some destocking of inventories among its distributors, which added to the pressure on its shares. After speaking with Zurn's management, we believe that expectations have been reset and that the recent forecast should prove overly conservative. Gaining 43% was **Axon Enterprise**, the manufacturer of non-lethal Taser stun guns and body cameras, as well as a provider of other services for law enforcement. At a law enforcement conference early in the quarter, the company also presented to analysts and discussed future avenues for the application of its technology to reduce handgun usage by police. In addition, Axon's new CFO reiterated the company's focus on further improving its margins. The company followed that mid-quarter by reporting revenues, earnings, and forward guidance that surpassed expectations. Sales grew significantly across all divisions and margins were better than expected. We trimmed our position on that strength. Added to the strategy this quarter was **A.O. Smith Corporation**, the leading global manufacturer of residential and commercial-grade water heaters and boilers. The company saw a rebound in orders after a period of steady inventory destocking, which added to our assessment that A.O. Smith was poised to benefit from increased sales and improving margins. In addition, its sales in China have stabilized.

Looking forward into 2023, many investors remain fixated on the macroeconomic environment. Which central bank will blink first by pausing—or even reversing—its quantitative tightening? Will those actions effectively reduce global inflation? How shallow or deep will 2023's widely anticipated recession be? As bottom-up investors, our attention zeroes in on a company's fundamentals and capital structure. While the contraction of P/E multiples weighed on nearly all stocks last year, many continued to increase their earnings and have stronger balance sheets than they did before the last recession. Stocks with that combination have a larger place in our strategy because we believe they will be well-positioned no matter what 2023 holds. As always, we are available for any questions you might have as we endeavor to protect the assets you have entrusted with us.

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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.*

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*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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