# U.S. Mid Cap Growth Strategy

**Representative Commentary — 1Q23**

## Performance

| | | | Annualized | | | |
|---|---|---|---|---|---|---|
| | **1Q23** | **1YR** | **3YR** | **5YR** | **7YR** | **10YR** |
| U.S. Mid Cap Growth Composite (Gross) | 7.63% | -6.75% | 18.00% | 11.60% | 13.24% | 12.12% |
| U.S. Mid Cap Growth Composite (Net) | 7.42% | -7.49% | 17.07% | 10.72% | 12.35% | 11.24% |
| Russell Midcap® Growth Index | 9.14% | -8.52% | 15.20% | 9.07% | 11.24% | 11.16% |

***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.***

It was a rollercoaster ride for global equity markets for the quarter, featuring considerable volatility. Most indexes ended positively in the mid-to-high single digits. The year began with optimism fueled by China's reopening of its borders to tourists. A mild winter along with decreased energy demand brought welcome relief to Europe. These signs of vigor have been recognized by central banks, which may need to take action for longer than previously anticipated in order to bring inflation under control. Global manufacturing activity has decelerated, though it appears the supply chain challenges are fading. Geopolitical uncertainty remains a prominent consideration, with the war in Ukraine passing the one-year mark.

In the U.S., equities weathered a banking crisis and a lack of clarity for what is in store for the economy. While the labor market remains strong, consumers continue to dip into savings that were accumulated during the pandemic. Home prices are falling across much of the country, with elevated mortgage rates dampening purchase activity. The Federal Reserve raised interest rates by 25 basis point increments for both February and March, while also keeping a watchful eye on lending in recognition of recent banking system stress. Growth outperformed value by a wide degree, with lower valuation stocks lagging among small-to-mid capitalization growth companies. The Energy sector gave up some of its past gains with falling oil and natural gas prices.

Amid this environment, the portfolio underperformed the Russell Midcap® Growth Index in the first quarter. There was relative weakness in the Consumer Discretionary, Health Care, and Industrials sectors, with mixed results from Financials. That was partly offset by strength from our positions in the Information Technology sector.

There were challenges this quarter among our holdings in the Consumer Discretionary sector. One example was the -8% decline for shares in **Ross Stores**, which operates retail, apparel, and home fashion discount stores. While Ross's results for the trailing quarter were higher than anticipated, guidance for the next quarter disappointed many investors. The recent buying environment was extremely favorable, though Ross saw higher expected wages and felt that a conservative forecast was the prudent course. As Ross's share price retreated in early March, we added to our position after having trimmed it in January at higher prices. Lagging the benchmark sector average return of 10% with its 1% showing was **O'Reilly Automotive.** A specialty retailer and supplier of auto parts, tools, supplies, and accessories, O'Reilly reported revenues and earnings that outstripped expectations on broad strength across product categories and market segments. However, the company's forward guidance was restrained because management plans to invest in new stores and to expand distribution centers to capitalize on those business gains. Far better was the 41% gain from **Floor & Decor**, which operates retail and online stores for tile, wood, laminate, and natural stone flooring. Recent revenues were slightly below expectations, though earnings exceeded them because lower freight costs boosted margins. There was growth in sales to professional remodelers as Floor & Decor had meaningful enrollment increases in its *PRO Premier* rewards program.

Also gaining ground in the first quarter was **Aptiv PLC**, which supplies automotive electronic technology for safety and entertainment systems. The company reported revenues and earnings that were higher than expected, though initial guidance for 2023 was conservative. Aptiv's management projected flat or declining global automotive production, though expected it would see increased sales per unit. Later at its analyst day, Aptiv's management also noted that overall profitability would steadily improve for the next two years as those increased sales came from higher margin systems. That combined to lift its shares by 20%. New to the strategy this quarter was **Five Below**, a discount retailer focused on teens and pre-teens with most goods priced less than $5. At the start of the year, Five Below's management provided a positive update from the recent holiday sales and reaffirmed its prior guidance range, though noted the strong sales would bring it to the higher end of that limit. The company was executing its sales strategy well and had caught up with the projected pace of opening new stores. We expect that Five Below's year-on-year comparisons will be favorable in 2023, its management has positioned the company to navigate a difficult economic environment, and the recent bankruptcy of Party City may provide it many new locations.

The Health Care sector also faced difficulties. Future concerns weighed on the shares for **Encompass Health Corporation,** one of the largest U.S. providers of post-acute services, such as rehabilitation. Encompass's revenues and earnings were better than expected, with labor costs under control and patient volume growing. Encompass's initial guidance for 2023 appeared conservative and later there were concerns that a future federal rule might encourage expedited discharges from inpatient rehabilitation facilities to home health settings. That led its shares down by -9%, though in our view, the conservative projections were typical for Encompass and no rule changes of the latter type were likely until late 2024 at the earliest. Hence, we added to our position. Transitory concerns affected **AmerisourceBergen Corporation**, which distributes pharmaceutical and medical products to pharmacies, hospitals, and other health care providers. The company's revenues were in line with expectations and earnings exceeded them. AmerisourceBergen's management increased its guidance for the balance of the fiscal year by a larger margin than the quarter's positive surprise. The subsequent -3% price retrenchment appeared to be a function of the shares having previously approached full valuation—coincidently when we trimmed our position—and concerns about future stock sales from its major shareholder, Walgreens Boots. Offsetting those impacts was **IDEXX Laboratories**, a global provider of diagnostic equipment and lab services for veterinary practices. IDEXX bested investor expectations for recent revenues and earnings, and initial guidance ranges for 2023 bracketed projections. Delving further into IDEXX's management outlook, the guidance appeared conservative. That lifted its shares by 23%, though we trimmed the position on that gain.

In the Industrials sector, there were greater rewards among the more cyclical segments compared with the more stable secular growth areas. One example of the latter was the -11% pullback for commercial real estate data and analytics provider **CoStar Group.** The company's revenues and earnings were higher than anticipated, though guidance for 2023 was less than expected. CoStar had considered buying News Corp.'s real estate listing services, which included realtor.com and related residential operations, but that deal was cancelled in February. Instead, CoStar will develop further its own residential offerings, though that will lead to greater near-term expenses. We have seen CoStar make these investments successfully in the past, so despite the market's disappointment we added to our position. We felt differently about **Booz Allen Hamilton**, an outsourced information technology consulting and services provider to U.S. government departments and agencies. Recent revenues and earnings were in line with expectations, though the rate of translating its order backlog into revenues declined as some larger orders delayed their start dates. We decided to exit the position, which was down -11% while we held it during the quarter. Gaining only 3%--compared with the benchmark sector average return of 10%--was **Cintas Corporation**. The largest U.S. provider of rental uniforms and related services, Cintas reported revenues and earnings that edged above expectations, and increased its forward guidance by that same excess level. The share price reaction seemed tempered by broader macroeconomic concerns that could affect Cintas's customers. More beneficial to the strategy was the 21% gain from **A.O. Smith Corporation**, a leading global manufacturer of residential and commercial-grade water heaters and boilers. A.O. Smith outpaced expectations for recent revenues and earnings, as well as for its 2023 business projections. Most of the inventory destocking has finished among A.O. Smith's customers, and declining steel prices led to higher margins. In addition, the company's prospects in China significantly improved with the removal of that country's zero-COVID restrictions. Another contribution came from **Copart, Inc**., which provides a range of auction, salvage, and remarketing services to process and sell vehicles. Its revenues and earnings bested expectations from higher-than-anticipated service volumes. Though fuel expenses have increased, the frequency of total losses has been growing, which should lead to higher activity levels for salvage. This quarter, that translated to a 24% share price gain. During the quarter, we sold our holdings in Rockwell Automation and began new positions in Watsco and Knight-Swift. **Rockwell Automation** designs and produces industrial automation products and services, and its shares approached our price target at the start of the year. We began trimming, then

Rockwell's price surged after the company revenues and earnings far outstripped expectations. The company's order backlog stood at historically high levels—though some of that included a faster pace of 2023 orders ahead of a planned price increase. We felt Rockwell's stock was nearly priced to perfection for the near term and completed our exit. New to the strategy was **Watsco, Inc**., a commercial distributor of air conditioning, heating and refrigeration equipment and related parts. Recent regulatory changes mandating higher efficiency levels for heating ventilation and air conditioning (HVAC) equipment should support a significant upgrade cycle, which bodes well for Watsco's HVAC sales even if the pace of new residential building slows. Also entering the strategy was the truckload freight company **Knight-Swift Transportation**. The current spot rates for truckload (TL) pricing appeared to bottom and Knight-Swift was well-positioned to see its earnings accelerate with incremental growth from its less-than-truckload (LTL) operations that helped balance the TL side.

Results were mixed in the Financials sector. The troubles for Silicon Valley Bank weighed on the rest of the banking industry, including our position in **Signature Bank**, a commercial bank serving businesses and private clients, predominantly in the New York metropolitan area. As concerns grew in early March about potential deposit outflows, we sold our remaining shares. Signature's share price fell -35% during the quarter while we owned it, though we exited before regulators closed the bank. Far better was the 14% gain from **Interactive Brokers Group**, which offers automated, low-cost securities brokerage services for global retail investors. Unlike other discount brokers, Interactive traditionally offered clients a competitive interest rate on balances so it was not as susceptible to asset outflows as many competitors were. In addition, though it held a large portfolio of fixed income securities, Interactive has been conservative in terms of credit quality and duration, so it was not as buffeted as other financial service companies. We trimmed our position on its relative strength.

The Information Technology sector was a bastion of strength this quarter. At the lead with a 43% gain was **Palo Alto Networks**, a global provider of network and cloud-based cybersecurity systems. Palo Alto's revenues grew higher than expected, as did margins, which led to notably better-than-expected earnings. More of Palo Alto's clients were availing themselves of multiple product offerings, and the company saw annual recurring revenue grow significantly for its Next Generation Security platform. With larger backlogs and billing rates, Palo Alto's guidance for the next quarter and the balance of the fiscal year outpaced estimates. Designing high-performance power management semiconductors, **Monolithic Power Systems** gained 42%. Its revenues matched expectations, though earnings bested them, and forward guidance matched what was generally anticipated. Following a prior quarter when Monolithic's guidance was less than expected, the market showed relief that order rates may be reaching a nadir early in 2023 before rebounding later this year. One notable detractor in this sector was the -3% showing from **Gartner, Inc**., which offers independent and objective research and analysis on information technology, computer hardware, software, and communications. We trimmed the position at the start of the year following its relative strength in 2022 (when Gartner had a 0% return versus the -27% decline for the benchmark). Later, Gartner reported better-than-expected results for the trailing quarter though its initial guidance for 2023 incorporated a high level of uncertainly and underwhelmed the market despite management's view that it included "the opportunity for upside." Returning to the contributors, **CrowdStrike Holdings'** shares climbed by 30%. Revenues and earnings bested expectations, as did 2023 projections for this cloud-based network security service that supports a range of devices and endpoints. CrowdStrike's rate of new business wins remained high, and a record number of net new customers propelled its annual recurring revenue growth to record levels as well. Lastly, we established a new position in **Teradyne, Inc**. A leading producer of testing and measurement equipment for semiconductors and other complex electronic systems, Teradyne seemed at an inflection point after several quarters of downward revisions. We believe that several of its end markets should stabilize in 2023 and that Teradyne was well positioned to benefit from rising chip complexity, which ultimately requires greater test intensity.

While recession concerns persist, employment data has remained stable. Earnings reports include cautious guidance amid macroeconomic uncertainty. As bottom-up investors, we remain focused on business fundamentals. While quality can be in and out of favor by the market at certain points, we believe these types of businesses are well positioned to perform well over time. As always, we are available for any questions you may have as we endeavor to protect the assets you have entrusted to us.

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*This composite invests in stocks with market capitalizations at time of purchase generally within the range of capitalizations of stocks in the Russell Mid Cap 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 75 stocks. Historical turnover has averaged 51% per year. Composite inclusion threshold $5mm. Fee basis is 80 basis points. The composite creation and inception date is October 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 mid cap market as represented by the Russell Midcap® 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 August 2007, TimesSquare had modified its purchase capitalization range to match the mid cap market as represented by the Russell Midcap® Growth Index at that time, with a change from $1.5 billion to $10 billion at time of purchase to $2.5 billion to $15 billion.*

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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 Midcap® Growth – a market capitalization-weighted index that measures the performance of those Russell Midcap® companies with higher price-to-book ratios and higher forecasted growth rates. All indexes,*

*including the Russell Midcap® 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.*

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***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 and sustains 10% annual gross return for each year during this period. If an advisory fee of 0.80% of average assets under management is charged per year, for each year of the ten-year period, the resulting annual net return would be 9.2%. The ending dollar value of the account would be $48,223,239, as compared to $51,874,849 if the advisory fees had not been deducted.*

*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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