BROWN CAPITAL MANAGEMENT

# The Brown Capital Management Small Company Fund

## Management Discussion of Fund Performance, Third Quarter 2020

**Small Company Fund—Investor and Institutional Share Classes**

Following two of the most volatile quarters in recent years, the U.S. equity markets were relatively steady during the third quarter. However, below the surface, the market continues to grapple with the push and pull of the opposing factors of the economic slowdown from the coronavirus pandemic, and the unprecedented monetary and fiscal stimulus that has followed. What the future holds remains highly uncertain, given the upcoming U.S. presidential election, potential for a second wave of COVID-19-related shutdowns, and the indeterminate shape of the economic recovery from here. Then, of course, there was the announcement in early October that the President, First Lady and several government officials have tested positive for the coronavirus.

With both our daily lives and the markets steeped in uncertainty, we believe this is an important time to step back and provide further perspective on our *long-termism*. There are three levels to our long-term investment philosophy—the nature of the Exceptional Growth Companies (EGCs) we invest in; the patience and tolerance we demonstrate in managing the funds; and the long-term commitment of you, our clients.
The first critical component of our long-term investment philosophy is our focus on selecting what we believe to be EGCs. By their very nature, EGCs are built for long-term growth. EGCs possess, among other things, durable revenue streams, sustainable competitive advantages that can withstand the test of time, and a large market opportunity that offers a long runway for growth. These characteristics give us the confidence that regardless of short-term macroeconomic conditions or exogenous events, EGCs can grow and generate value over a long time horizon.

The second level of our long-termism has to do with our behavior as portfolio managers. Hypothetically, one could invest in EGCs but actively trade in and out of them. Instead, we take a long-term perspective to our holdings, based on patience and tolerance. Patience allows us to often hold EGCs for years and decades in order to realize their true potential. Tolerance gives us perspective when a portfolio company hits a temporary roadblock, and allows us to give the company the time and space to overcome short-term impediments. Together, our patience and tolerance produce long holding periods. Our initial horizon for evaluating EGCs is 3-5 years out, but we often hold our portfolio companies for much longer. In fact, more than 40% of our portfolio companies have been held in the fund for 10 years or more. Portfolio turnover tends to be less than 20% in any given year; in the five years to Sept. 30, 2020, annualized turnover was just 13%, using the representative account in our composite.

The final, vital element of our long-termism has to do with you, our clients. By and large, our clients take a similar, multi-year perspective in investing with their asset managers. The confidence they place in us comes from knowing us well. Our clients understand that we don't pay attention to benchmarks and we manage a relatively concentrated fund of 40-65 companies, so our fund can behave very differently from the indexes. We believe our success in implementing a differentiated investment philosophy requires close partnership with clients who are likeminded, long-term thinkers. We truly appreciate you taking the time to understand our strategy, and for investing with us for the long-term.

During the third quarter of 2020, the Small Company Fund underperformed the Russell 2000® Growth Index, which climbed 7.16%. Year to date, the Small Company Fund outperformed the Russell 2000® Growth Index's 3.88% return. As mentioned, our performance can vary meaningfully from that of the benchmark in either direction.

**Returns—Contributors and Detractors**

Among the top contributors this quarter were iRhythm Technologies (IRTC) and Veeva Systems (VEEV).

**iRhythm Technologies** is a medical-device company whose flagship solution, the ZIO Service, allows physicians to diagnose heart arrhythmias more quickly and effectively than traditional technologies. The ZIO XT Patch is a patient-worn biosensor that captures heartbeat data continuously for up to 14 days, representing 20,000 to 30,000 pages of data per patient. Following the wear period, the patient sends the ZIO XT Patch to an iRhythm diagnostic center, where the data is analyzed using machine-learning algorithms. A certified cardiac technician then combines the output into a simple and actionable report for the prescribing physician to use. The ZIO Service has been shown in multiple peer-reviewed studies to detect more arrhythmias compared to legacy Holter monitors, which are larger devices and can only be worn for 1-2 days. In addition, accurate detection and higher diagnostic yield allow the physician to more quickly prescribe the appropriate treatment options for patients, and help avoid more serious downstream medical events, including stroke.

During the third quarter, iRhythm's Zio XT cleared a meaningful reimbursement hurdle. In 2012, the Zio XT was categorized by the Centers for Medicare and Medicaid Services (CMS) as a new technology, and was issued a temporary Current Procedural Terminology (CPT) code, which is used to determine reimbursement—hence pricing—for the service. Given that traditional Holter monitoring is reimbursed at lower rates, there had been some concern among investors that when a permanent CPT code is issued for the Zio, it will have a lower reimbursement rate. However, when the CMS published its proposed 2020 physician fee schedule in August, it actually showed a slight increase in reimbursement for Zio, versus expectations for a potential decrease. This led to iRhythm's outperformance during the quarter. We see a long runway for growth for the company given its low penetration in a large market and strong competitive position.

**Veeva Systems** provides cloud-based software to the global life-sciences industry. Veeva's modern Customer Relationship Management (CRM) solution offers greater functionality and integration than competitors', and has a dominant market position in the pharmaceutical market. Veeva Vault is an open-ended content management and collaboration platform on which the company has launched multiple successful products for the clinical side of life-sciences companies. These include eTMF (electronic Trial Master File), CTMS (Clinical Trial Management System), CDMS (Clinical Data Management System), regulatory, quality and safety-management solutions, all of which have significantly expanded the company's market opportunity over time. Finally, Veeva has begun to sell solutions outside of life sciences in recent years, further growing its target market. Going forward, we see a large opportunity for cross-selling, continued innovation and market expansion.

During the quarter, Veeva again delivered strong revenue growth and cash-flow generation, with little impact from COVID-19-related shutdowns. The company's customers, who are mostly in the life-sciences vertical, have been relatively unscathed in recent months, and continue to expand their use of Veeva products. The company's outperformance during the quarter was likely driven by strong execution and growth, enhancing its position as a best-of-breed software company.

Among the largest detractors for the quarter were Alteryx (AYX) and PROS Holdings (PRO):

**Alteryx** provides comprehensive self-service data-analytics software to data scientists and business analysts for finding and sharing data, preparing and blending it, performing a variety of analysis, sharing insights, and automation, without the need for coding. Alteryx's software is unique in combining a comprehensive data-analytics platform with ease of use, driving dramatic improvements in business productivity and outcomes. We believe Alteryx has a large market opportunity given its ability to help data scientists as well as business analysts who have limited technical capabilities. Alteryx serves a broad base of customers across all verticals and all sizes.

During the second quarter, Alteryx reported slower revenue growth relative to prior periods, and guided down full-year revenue below expectations. The revenue slowdown was partly driven by customers in certain areas that were heavily impacted by COVID-19, like small businesses and companies in the hospitality vertical, that slowed spending on new purchases and expansions. Additionally, the company noted that some customers are taking longer to make purchase decisions, extending sales cycles. These developments led to the underperformance during the third quarter. We believe the revenue slowdown is a short-term phenomenon, and continue to believe Alteryx has a large market opportunity and a long runway for multiyear growth.

**PROS Holdings** uses software embedded with artificial intelligence and machine-learning algorithms to help customers optimize pricing for their products and services. PROS' beginnings were in providing data analytics and dynamic pricing to the airline industry, and the company has become a dominant provider of pricing optimization for companies in the travel vertical. PROS has since developed a suite of products for companies that sell to other businesses, commonly known as B2B (Business to Business) companies. PROS' digital pricing and CPQ (configure, price, quote) software enables B2B customers to offer consistent pricing across physical and digital channels, while optimizing pricing and profitability. The software helps B2B customers digitize their sales processes, and has seen strong demand in recent years as all types of companies have been under pressure to enable online selling.

Over the past few months, COVID-19 has had an unprecedented impact on airlines, hotels, and other travel and transportation companies. With roughly 45% of revenue coming from the travel industry, PROS has seen several of its customers pause expansions and new purchases, although renewals remain steady. While revenue from other verticals has been more resilient, it has not been immune from coronavirus-related slowdown in new business activity. As a result, PROS has experienced a meaningful slowdown in revenue growth this year, which has likely weighed on the company's performance. While the travel vertical is likely to see a long road to recovery, PROS' software remains critical to airline and other travel customers. We see a large market opportunity in the B2B space and expect growth to recover faster in this market.

## Purchases and Sales

We eliminated one holding, Endologix (ELGX), from the portfolio during the third quarter of 2020. No new positions were added.

**Endologix** develops and sells minimally invasive medical devices for the treatment of abdominal aortic aneurysms. An aneurysm occurs because of a weakening of the vessel wall, with a rupture resulting in an 80% mortality rate. We invested in the company back in 2016 as its differentiated portfolio of products could treat a variety of aneurysms. Endologix significantly underperformed over the holding period due to a delay in FDA approval of a key product, Nellix, a temporary self-imposed manufacturing delay on its flagship AFX2 product, and other issues. We believe the company's technology is differentiated and helps save lives. However, execution on the part of management has been disappointing, resulting in the company being placed on our Challenged List. During the third quarter, the negative impact of COVID-19 was the final straw that drove the company to file for bankruptcy—the only time in our fund's 28-year history a portfolio company has gone bankrupt. As a result, we sold the company out of your investment program. In hindsight, we were perhaps too tolerant of management's struggle to resume growth, given the impact of its missteps on profitability and the balance sheet.

## Closing Thoughts

Thank you for your continued support of Brown Capital Management.

**As of 09/30/2020***

| Company Name | Percentage Held in Portfolio |
|---|---|
| Irhythm Technologies Inc. | 5.5 |
| Veeva Systems Inc. | 5.4 |
| Alteryx Inc. CLA-A | 3.9 |
| PROS Holdings | 1.7 |
| Endologix Inc. | --- |

*Subject to Change

# The Brown Capital Management Small Company Fund

## Management Discussion of Fund Performance, Third Quarter 2020

The table below shows the performance of the Fund versus several market indices:

| As of 09/30/2020 | | | | Annualized | | | |
|---|---|---|---|---|---|---|---|
| | QTD | YTD | 1 Year | 3 Years | 5 Years | 10 Years | Since Incept.* |
| **Small Company Fund Inv. Class** | **5.29%** | **21.47%** | **26.91%** | **18.01%** | **18.91%** | **17.28%** | **12.97%** |
| **Small Company Fund Instl. Class** | **5.35%** | **21.65%** | **27.17%** | **18.24%** | **19.16%** | **17.49%** | **13.05%** |
| *Russell 2000 Growth Index*** | *7.16%* | *3.88%* | *15.71%* | *8.18%* | *11.42%* | *12.34%* | *7.83%* |
| *Morningstar Small Growth Cat.**** | *8.53%* | *10.09%* | *20.56%* | *12.11%* | *13.41%* | *12.92%* | *N/A* |

**The Fund's inception date is 7/23/92. Performance starting 12/31/92. Inception 12/15/11 for Institutional Share Class. Performance for the Institutional Class prior to 12/15/11 is based on the performance of the Investor Class.*

***Performance calculations reflect Average Annual Return for periods of one year or more.***

***The performance information quoted above represents past performance, which is not a guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For performance current to the most recent month-end, please call 1-877-892-4226.***

***The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.*

****Morningstar Small Growth Category Small-growth portfolios focus on faster-growing companies whose shares are at the lower end of the market-capitalization range. These portfolios tend to favor companies in up-and-coming industries or your firms in their early growth stages. Because these businesses are fast-growing and often richly valued, their stocks tend to be volatile. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small-cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value and cash flow) and high valuations (high price ratios and low dividend yields).*

*Note: One may not invest directly in an index.*

***An investor should consider the investment objectives, risks, and charges and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. A copy of the prospectus is available at the link below or by calling Shareholder Services at 1-877-892-4226. The prospectus should be read carefully before investing.***

*"Net Operating Expenses" are based upon actual expenses incurred by the Fund's Investor Shares for the Fiscal year ended March 31, 2020. Brown Capital Management, LLC (the "Advisor") has entered into an Expense Limitation Agreement with the Small Company Fund under which it has agreed to reduce the amount of the investment advisory fees to be paid to the Advisor by the Small Company Fund and to assume other expenses of the Small Company Fund, if necessary, in an amount that limits the Small Company Fund's annual operating expenses (other than interest, taxes, brokerage commissions, acquired fund fees and expenses, other expenditures which are capitalized in accordance with generally accepted accounting principles, other extraordinary expenses not incurred in the ordinary course of the Small Company Fund's business, and amounts, if any, payable under a Rule 12b-1 distribution plan) to not more than 1.25% until July 31, 2021. The Expense Limitation Agreement may not be terminated by either party prior to that date. Subject to certain conditions such as Fund asset levels being at certain thresholds and operating expenses being less than the operating expenses limit for the Small Company Fund, the Small Company Fund may reimburse the Advisor for fees waived or limited and other expenses assumed by the Advisor pursuant to the Expense Limitation Agreement. Reimbursement for fees previously waived are subject to Board approval and are only applicable to fees waived or limited and other expenses assumed by the Advisor in the prior three years. Each waiver or reimbursement of an expense by the Advisor is subject to repayment by the Small Company Fund within three years following the month in which the expense was incurred, provided that the Small Company Fund is able to make the repayment without exceeding the lesser of the expense limitation in place at the time of the waiver and/or reimbursement or the current expense limitation arrangement. See the "Management of the Funds-Expense Limitation Agreements" section in the prospectus for more detailed information. Information presented in this commentary should not be considered a recommendation to purchase or sell any particular security. There can be no assurance that any securities discussed or identified will remain in the strategy's portfolio or, if sold, will not be repurchased. The securities discussed or identified in this letter do not represent the strategy's entire portfolio and in the aggregate may represent only a small percentage of the strategy's portfolio holdings. It should not be assumed that any of the holdings discussed or identified have been or will be profitable, or that recommendations made in the future will be profitable or will equal the investment performance of the securities discussed or identified herein.*

*Principal Risks of Investing in the Fund: As with all mutual funds, an investment in the Fund is subject to investment risks, including the possible loss of the principal amount invested. There can be no assurances that the Fund will be successful in meeting its objectives. Investment in the Fund is also subject to market risk, investment style risk, investment adviser risk, market sector risk, equity securities risk, portfolio turnover risk, small companies risk. Funds that emphasize investments in smaller companies generally experience greater price volatility.*

*More information about these risks and other risks can be found in the Fund's prospectus.*

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