Polen US SMID Company Growth Q1 2022 Portfolio Manager Commentary

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Summary

- Polen Capital is a high-conviction growth investment manager. We scour the globe in search of the highest quality, sustainable companies to invest in.
- A broad-based selling of risk assets, high correlations, and a preference for the types of companies that typically do not meet our investment criteria dominated market behavior during the first quarter of 2022.
- Over the first quarter, Polen U.S. SMID Company Growth Composite Portfolio (the “Portfolio”) returned -23.81% gross and -24.02% net of fees, respectively.
- The top absolute contributors to the Portfolio’s performance over the first quarter included Aspen Technology, Endava, and Revolve Group.
- The most significant absolute detractors from performance included Trex Company, Etsy, and RH (formerly Restoration Hardware Holdings, Inc.).

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Seeks Growth & Capital Preservation (Performance (%) as of 3-31-2022)

	Qtr	YTD	1 Yr	3 Yr	5 Yr	Inception
Polen US SMID Company Growth (Gross)	-23.81	-23.81	-9.16	-	-	38.15
Polen US SMID Company Growth (Net)	-24.02	-24.02	-10.24	-	-	36.65
Russell 2500 Growth	-12.30	-12.30	-10.12	-	-	29.82

The performance data quoted represents past performance and does not guarantee future results. Current performance may be lower or higher. Periods over one-year are annualized. Please reference the GIPS Report which accompanies this commentary.

The commentary is not intended as a guarantee of profitable outcomes. Any forward-looking statements are based on certain expectations and assumptions that are susceptible to changes in circumstances.

Commentary

Global equity markets got off to a rocky start over the first quarter of 2022, with inflation, monetary tightening and slowing economic growth continuing to take center stage. Russia’s invasion of Ukraine caused a global shock that sent commodity prices soaring, given Russia is a key producer of oil, gas and wheat. Supply chain constraints and inflationary pressures were amplified, while heightened geopolitical risk contributed to a more volatile U.S. equity market.

Broad-based selling of “risk” assets and a preference for the types of companies that typically do not meet our investment criteria dominated market behavior during the first quarter. Whereas we tend to avoid investing in commodities companies and those that are more cyclical in nature, energy, and utility companies were among the strongest performers over the quarter.

There was a noticeable lack of differentiation by investors between what we consider to be high-quality companies – meaning those that are fundamentally strong – and the rest of the market.

> Indiscriminate market pullbacks that disregard the quality of a business often spell opportunity for investors like us.

Short-term rotations have no bearing on how we invest, as we believe long-term returns will ultimately reflect our holdings’ growth in cash flow and earnings over longer periods. That said, we believe the valuation reset in long-duration assets, especially in the higher-growth segments of the U.S. small- and mid- capitalization equity spaces, is healthy for these markets. No longer as constrained by valuation headwinds and its impact on potential internal rates of return (IRR’s), we believe we now have a better opportunity set and increased potential to seek out investment ideas that should offer attractive long-term outcomes. These opportunities are at the intersection of quality and growth that meet our mid-teen’s IRR hurdle.

Portfolio Performance & Attribution

Over the first quarter, the Polen U.S. SMID Company Growth Composite Portfolio (the "Portfolio") returned -23.81% gross and -24.02% net of fees, respectively, underperforming the Russell 2500 Growth Index's -12.30% return. The only GICS sector that generated positive results during the quarter was energy – an area in which the Portfolio typically has no exposure. Our positions within the consumer discretionary, information technology, and financials sectors weakened in response to selling pressure as risk appetites waned. The Portfolio was also challenged from a style perspective, with investors more focused on value during the quarter. In our view, stocks with future growth potential were punished indiscriminately without an understanding of – or consideration for – their underlying fundamentals.

> Our focus continues to be on finding high-quality companies that benefit from long-term secular trends; are well-positioned in their respective markets; have robust, cash-generative business models; and are run by talented management teams.

We believe these qualities provide businesses with the ability to grow in any market environment and are important drivers of long-term performance.

The top absolute contributors to the Portfolio's performance over the first quarter included **Aspen Technology (AZPN), Endava (DAVA)**, and **Revolve Group (RVLV)**.

Asset optimization software company **Aspen Technology** is one of our long-time holdings. We anticipate growth in the business to accelerate as both customer demand and business conditions in many of the company's key end markets continue to improve. The company had been previously challenged, in part, by weaker energy prices and the impact of the pandemic. Still, we believe the strategic imperative for its customers to operate assets more efficiently and sustainably remains intact.

As an information technology consulting firm, **Endava** has benefited from the digital transformation trend, and reported favorable results during the first quarter. We believe Endava's future growth will be driven by the digital transformation space remaining strong in response to companies' need to reinvent and reimagine themselves. This is work that we view as being non-discretionary. Digital maturity is, in our opinion, a requirement for business longevity. Our research shows Endava is well positioned as the "employer of choice" in Central Europe, and this is reflected in its hiring performance – a key driver of growth.

Online fashion retailer **Revolve** had another favorable quarter, and our investment in this company has continued to compound at a high level. We were impressed with the company's recent results, especially the combination of customer growth, the growing number of orders per customer, and improving average order values. We believe the company still has considerable room for growth as it benefits from the bourgeoning trend of fashion going online, while its investments in adjacent categories, like beauty, are increasing the market opportunity its addressing.

The most significant absolute detractors from the Portfolio's performance over the first quarter included **Trex Company (TREX), Etsy (ETSY)**, and **RH (RH) (formerly Restoration Hardware Holdings, Inc.).**

Trex is the world's largest wood-alternative decking and railing manufacturer and has nearly 30 years of product experience. Despite continued robust results, the company's stock price fell some 50% from its December 2021 high. We took advantage of the pullback to add to our position in Trex. We have received some questions about the impact of rising interest rates on the company's business model. In the past, we have observed that rising interest rates and higher home values often favor consumers staying longer in their homes and continuing to spend on repairs and remodels. We would add that a more significant driver here is the long-term shift from wood to composites, which seems to be accelerating. This is consistent with the changing preferences we are observing around environmental sustainability.

E-commerce company **Etsy** has experienced challenges from the return to "normal" after the pandemic. Management made a point of lowering expectations for 2022, sounding more cautious in areas like home furnishings. We appreciate that there will be reopening headwinds for businesses like Etsy that create noise in the numbers, but this does not change our view on the long-term potential for the business. We are encouraged by Etsy's performance retaining new customers added during the pandemic and driving repeat purchases within this customer segment. This is, in our opinion, a healthy sign that these customers have staying power.

RH is a furniture store company with brand recognition and a unique business model. The company's stock price fell sharply over the first three months of 2022 despite solid operating results, which resulted in what we believed to be an attractive opportunity to add to our position in the company. We are mindful that, on the margin, the company is certainly experiencing some early impact from record inflation and rising interest rates, and we feel comfortable in both the management team's ability to navigate these challenges and the power of the company's brand and its long-term potential.

Portfolio Activity

We initiated positions in **Endava, Floor & Decor Holdings (FND)**, and **Five Below (FIVE)** during the first quarter, while exiting **EPAM Systems (EPAM), CDW Corporation (CDW), Exponent (EXPO)**, and **Medpace (MEDP)**.

During the quarter we bought **Endava**, an IT services company that is helping its customers with digital transformation. Often companies do not have the talent in-house to unlock their potential. Headquartered in the U.K., the company is a market leader with a business model predicated on having near-shore delivery centers in similar time zones. This allows the company to benefit from operating in locations such as Moldova, where labor costs are lower and the talent pool is deep.

Endava can help an organization reimagine and reinvent itself by helping it catch up to the changing preferences and behaviors of its customers in the digital world. Endava can help companies futureproof their organizations – a must for any business to succeed. The position in Endava replaced the Portfolio's position in **EPAM Systems**, largely in response to EPAM's higher market cap. We were lucky to sell EPAM before the war in Ukraine began.

We added **Floor & Decor** during the quarter. We had previously owned this company in our U.S. small-cap strategy and sold in response to its growing market cap. The recent dislocation between the company's share price and its solid underlying fundamentals compelled us to add this holding to the Portfolio. We see a long runway for the company's growth, which posted record sales and expanded by more than 40% in 2021. Floor & Decor's strategy is to add new stores, improve comparable sales, and grow its e-commerce business. The company continues to reinvest in the business, particularly in areas where customer economics are desirable, including professional sales and design services. We believe in the company's future growth prospects and its compounding potential.

During the quarter, we added a position in **Five Below**, a leading high-growth value retailer focused on high-quality, trend-right products that are targeted to teens. This is also a previous holding. The company offers a fun treasure-hunt shopping experience and, with most items priced between $1 and $5, Five Below attracts a wide range of customers to its 1,200 stores across 40 states. We had previously owned the company during the pandemic but sold it in response to concern about the business's reliance on physical storefronts and foot traffic. With the economy reopening and the stock pulling back over the last several months, we believed Five Below was again an attractive investment. The company has potential to grow its store base, compelling store economics and a value-orientation in a potentially difficult economy. We're excited about the company's plans to triple its store base by 2030, as well as to double its top and bottom line by 2025. Based on expectations of 15% square footage growth annually, modest store comps, and limited margin improvement over the next eight years, we believe there is significant upside potential for the company.

We sold **CDW** from the Portfolio to make room for companies we believed offer more attractive risk/reward profiles. CDW is a high-quality company that continues to execute well. It has exceeded the pace of U.S. information technology spending, gained market share globally, and further penetrated the higher-end services that its customers need. That said, the company is at the upper end of our market-cap range, and we believe it no longer offers the compelling return potential we look for, given its lower-growth profile, vulnerability to supply chain issues, tight margins, and premium multiple to peers.

We exited our position in research company **Exponent** in response to what we believed to be an unsustainable trajectory as it pertains to utilization and talent acquisition. A critical leading indicator, average full-time equivalent employees was up only 1% in the fourth quarter of 2021 and down 1% over the full-year 2021. We believe the company might be having issues recruiting and/or retaining talent. This is a people business that we believe is subject to risks related to the company's ability to drive sustainable growth at the levels we expect from Exponent. We also believed the company was a good candidate for sale based on what we believed to be a lower expected return relative to other Portfolio holdings and companies in the research process.

We sold the Portfolio's position in **Medpace** due to the potentially challenging biotech funding environment and because the company faces wage inflation that could jeopardize the profitability of its existing contracted business. Combined with a less compelling return potential relative to other Portfolio holdings, based on our research, the sale of Medpace provided us with a good source of funds to apply to what we believed to be more attractive investment opportunities.

Outlook

While the uncertain and volatile macroeconomic environment may result in slower near-term economic growth, we continue to see an exciting and attractive runway for our Portfolio companies over the long term. This is particularly notable in the context of recent market movements. Overall, we see these holdings' as having more attractive IRR's going into the second quarter of 2022 in part because of their managements teams' ability to demonstrate financial flexibility and navigate difficult conditions.

> In the short term, shifts in market behavior may not calibrate to our way of thinking. That said, this divergence opens doors for us to opportunistically invest in businesses we believe have the possibility to grow much larger over a longer period and that have more attractive return potential than they did previously.

By focusing on finding the best companies at the intersection of quality, growth and meeting our expected IRR hurdle, we believe the Portfolio is well positioned for when the market becomes more discerning around the underlying fundamentals of the businesses we own.

Thank you for your interest in Polen Capital and the U.S. SMID Company Growth strategy. Please feel free to contact us with any questions.

Sincerely,

Rayna Lesser Hannaway

GIPS Report

Polen Capital Management U.S. SMID Company Growth Composite—GIPS Composite Report

	UMA	Firm	Composite Assets	Annual Performance Results

Year End	Total ($Millions)	Assets ($Millions)	Assets ($Millions)	U.S. Dollars ($Millions)	Number of Accounts	Composite Gross (%)	Composite Net(%)	Russ Grow
2021	82,789	28,884	53,905	4.95	7	22.03	20.64	5.05
2020[1]	59,161	20,662	38,499	0.51	1	105.23	103.70	82.91

[1]Performance represents partial period (April 1, 2020 through December 31, 2020), assets and accounts are as of December 31, 2020.

[2]A 3 Year Standard Deviation is not available for 2020 due to 36 monthly returns are not available.

N/A - There are five or fewer accounts in the composite the entire year. Total assets and UMA assets are supplemental information to the GIPS Composite Report. While pitch books are updated quarterly to include composite performance through the most recent quarter, we use the GIPS Report that includes annual returns only. To minimize the risk of error we update the GIPS Report annually. This is typically updated by the end of the first quarter.

Original Post

Editor's Note: The summary bullets for this article were chosen by Seeking Alpha editors.

Additional disclosure: Polen Capital Management is an independent registered investment adviser. A list of all composite and pooled fund investment strategies offered by the firm, with a description of each strategy, is available upon request.

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