

The Compelling Opportunity in Emerging Growth Stocks

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by Robert Huebscher

James L. Callinan is a portfolio manager for the Osterweis Emerging Opportunity Fund (OSTGX). The fund focuses on identifying high quality companies in emerging industries and defensible growth niches that have open ended growth potential. It seeks to buy the stocks of such companies before they are discovered or when investors are very skeptical about future prospects.

I spoke with Jim last month.

Bob: You've been investing in growth companies for over 30 years. What have you learned over that time?

James: I've learned a few things. In the 1990s, you were able to buy a growth stock and if everything was in motion, the stock would stay in motion. If the earnings came through, the stock would continue to rise almost to an unreal level of valuation. But over the last 15 years, the market has been more reactive to various bits of news related to a stock so being disciplined about when you buy a stock has become more important in terms of both generating attractive long-term returns and managing risk. I still try to look for companies that have huge market and growth potential, but I have a valuation overlay. I want to buy these stocks when they've corrected significantly off their highs.

Bob: Are there other ways in which those lessons have changed your investment philosophy over time?

James: I think it is important to focus on companies that clearly look like the leaders in their markets. I identify seven or eight spaces that are really exciting and fast-growing,

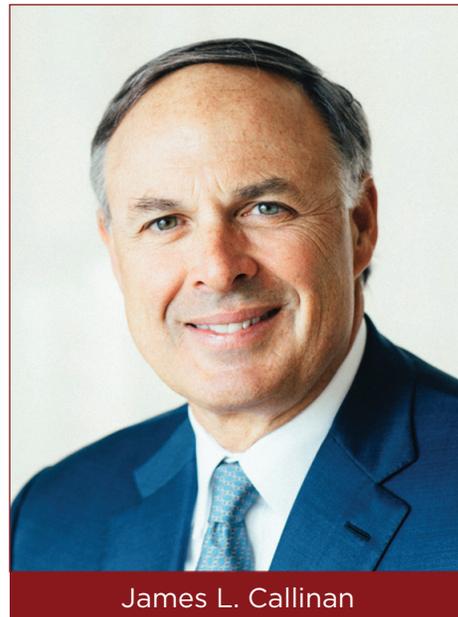
and then try to pick the best-positioned company in that space. At the same time, I don't want to buy into a company that is trading at an excessive valuation so I'm looking for a company that's attractively valued because it is really misunderstood or is somewhat mysterious because it's a new company in a new industry.

I also believe it is important to concentrate the portfolio, and that's something new. In the 1990s we had many, many potential investment options—there were four or five hundred IPOs a year. Now you're only getting about 70 or 80 venture-backed IPOs a year. This means there's a lot fewer really exciting ideas, and so the concentration makes a lot more sense.

In addition, we don't want to be just closet indexers. We think there is real value for an active manager when it comes to investing in smaller growing companies that likely don't have thorough, in-depth coverage by analysts and may be breaking new ground. I will say that the indexing trend has really grown as a percentage of ownership in each of the companies we own, so that a lot of movement in the stocks is really related to the flows of ETFs. In some instances outflows from ETFs may create buying opportunities for us.

Bob: What are the key success factors in emerging growth stock investing?

James: The first thing is to buy at the right price when there is a misunderstanding about the company. That's something I've learned through hard knocks over time. There was a time where you could buy a stock midway through its growth cycle and still get great outperformance. Today, there are



James L. Callinan

a lot more opportunities for a stock to get knocked down to a reasonable price when it's in its growth phase.

The second thing is that you have to be an optimist. You have to believe these emerging areas are going to be game changers. Often-times I think the venture capital community is right in identifying areas of opportunity. Let's just take a thing like software-as-a-service (SAAS). The venture community has been dead right on the growth of SAAS and how it's taken over corporate computing. They've also been extremely right on the rollout of optical networking. You have to be optimistic when these trends happen and look for opportunities to invest as the venture community brings new companies in emerging industries public.

It is also important to know management teams to help you really assess a company's ability to execute its strategy. The management teams of tech and health care start ups tend to be recycled over and

over and over again. Companies go public, they can thrive and become leaders, then they may get acquired by strategic investors, or they stumble. Experienced business managers in all three categories of outcomes are prized by venture backers as future leaders of new businesses. Because I've been in the business now for 30 years investing in these emerging-growth companies, I get to see management teams over overtime and understand their strengths and weaknesses.

Bob: Please describe your investment process. In particular, I understand that you use something called "anchor points." What are those and how they are established?

James: We start the process by looking at the stocks in the Russell 2000 Growth Index. This includes all the IPOs, all the emerging companies and a lot of older companies that aren't so emerging and aren't so "growth" but get into the growth side of the Russell 2000 Index. We screen that index quarterly to come up with a universe of about 150 stocks that we cover. That universe might change 40%-50% a year.

I closely look at those 150 companies with an analyst on my team. As I mentioned before, we're looking at that population for companies in emerging industries and defensible growth niches. We want to find an undiscovered or misunderstood company that should have sustainable and open-ended revenue growth of at least 20% for three to five years. Finally, we're looking for rising margins which may include companies that are losing money and then will break into profitability.

The "anchor point" is a statement by management that says, "In three

to five years we think we can sell 4,000 widgets." It's a quantifiable, measurable goal can be achieved without acquisitions. The company must have enough profitability and cash on its balance sheet to do all the things it needs to do to satisfy the anchor point. You don't want the company to have to buy a bunch of companies or raise equity or do anything outside the company to reach its anchor point target. Usually, the anchor point translates into an over 100% increase from the company's present earnings level.

Once we establish an anchor point, we put an earnings-per-share number on it to create an upside price target. This upside price target is used to assess valuations as we look for opportunities to enter a stock. As part of our ongoing process, we monitor the portfolio by watching the upside price targets to those anchor point earnings.

Bob: You mentioned earlier that you're a high conviction investor. How concentrated is the fund?

James: The fund composed of approximately 30 stocks now. In general the average position size will be about 3%. We believe in most heavily weighting our highest conviction stocks so our concentration could go as high as the top 10 being about 50%, equating to about 5% positions. Then the other 20 will be 2% or 3% positions.

David: At the end of last quarter, you had about 40% of the fund invested in technology. Is that too much exposure to one sector?

James: I agree it is easy to see 40% in the tech sector and think that is way too much exposure in one sector, but that is a superficial way to look at tech. The tech sector is made up of many different kinds of companies, creating market niches in existing industries

as well as brand new industries. In particular, there are a lot of companies that are considered tech companies, but they're really consumer-oriented. For example, Yelp, GrubHub and Square are classified as tech companies even though each of them has an advertising, ecommerce and financial function serving consumers, merchants and investment companies. About 10% to 12% of the fund is classified technology but we think should be labelled otherwise.

That said, I do think we will tend to have a fairly significant weighting in tech companies because technology is such a powerful growth driver for what we're trying to do in terms of concentrating a top-line position, achieving growth and delivering strong profitability.

Bob: Many people might think that your style of investing is quite risky. How do you manage risk in the fund?

James: One of the things that I have done is to utilize strategic cash. We try take our profits in certain stocks that have done really well, based on the anchor-point upside potential or sell aggressively when it looks like the companies is not going to achieve its anchor point goals. We are not afraid to have some cash on the sidelines to redeploy when volatility provides opportunities to pick up new stocks or add to positions at very attractive valuations.

After we buy stocks, we sometimes realize their upside potential very quickly. Those elliptical returns can happen in one or two quarters. When that happens we try to take the gains and cut the position sizes significantly. We then wait until the stock retreats to an attractive level again which often happens faster than expected.

Inevitably, after an elliptical run like

that, you can get corrections that are severe. We've tried to take the edges off these upside and downside price moves. We'll go back into the name when the volatility comes down.

Interestingly, over recent ten-year periods small-cap growth has had somewhat lower volatility than small-cap value. However, in the next few years, growth may resume its historical higher volatility. We believe our style can turn this volatility into an opportunity for investors.

Bob: Do you think that being in San Francisco provides you with a locational advantage?

James: Definitely. The San Francisco Bay area has historically been a leading area for startups. Los Angeles and Austin have become fertile ground for starting companies. Our San Francisco location is an advantage because you have two of the top three areas to start companies within a two-hour or three-hour flight. Additionally due to our proximity we are able to attend a lot of broker conferences and bus tours as well as analyst days. We also are able to have management teams meet us in our office.

Bob: What are some of the areas of the market where there are areas of opportunity now?

James: Relative to the long-term opportunity, technology, especially what I call consumer tech or consumer internet, was really was cheap this year. Those companies are well positioned to benefit from consumer-behavior changes. When you start a franchise like Yelp, GrubHub, Zillow or LendingTree, the consumer gets into a habit. Once they get into that habit, they keep doing it. Consumers are using companies like GrubHub and Yelp to make their lives easier. These types of companies recent-

ly corrected by about 15%-25%. When you get these broad market moves it can create an incredible opportunity to buy at attractive valuations. We think these companies are going to get to significant scale, and we wouldn't be surprised to see them merge into the larger franchises like Facebook, Google and Amazon. As you can tell, we think the consumer internet space is very exciting.

Semiconductors is also an interesting great area. As I mentioned, we like to own cutting-edge, mar-

“ Relative to the long-term opportunity, technology, especially what I call consumer tech or consumer internet, was really was cheap this year. Those companies are well positioned to benefit from consumer-behavior changes. ”

ket leading companies which are priced attractively. Semiconductors now address meaningful, large consumer categories such as autos, drones, cameras and gaming. These companies have 60% gross margins, defensible markets and reasonably low P/Es.

For example, Ambarella's chip technology compresses video data for transport and storage on wifi networks. When I originally bought Ambarella, I thought there were 60 million institutional units a year that it could sell for security cameras and now there's a potential billion units a year. That's an example of what I'm talking about in terms of multiples of a company's present size.

There's another company in semiconductors that I think is quite interesting. Inphi makes the linear chips for optical networks that have the fastest transport chips for data center and metro original equipment manufacturer (OEM)

optical systems. Their chips take an electronic signal, speed it up, heat it up and put it in an optical transmission. Microsoft is using them for custom chips that are part of strategies to enter the Amazon web services (AWS) area.

Health care is another interesting area as medical technology still allows for constant and continuous innovation. We like Inogen, which should benefit as the government puts pressure on the cost the oxygen cylinders used by people who have pulmonary disease. Inogen

is the only company that makes a low-cost, consumer-friendly backpack that makes oxygen for people who have to be on oxygen with nose cannulas. They are rolling out their technology right now with about a 50% gross margin. With Inogen's product a family would spend \$3,000 to buy a backpack that makes oxygen for their elderly relative who has pulmonary obstructive disease. This is very attractive compared to renting oxygen tanks.

Bob: What are some of the important growth areas over the next five to 10 years?

James: Financials, banks and S&Ls have been the last to adopt technology. Even though you can go online and get your bank statement, this whole area is going to change, and I want to have a position in that area. I have three or four stocks that I believe should benefit from this theme. Financial technology ("fintech") is going to change

a lot of things. Marketing, back-end processing and product creation using the internet are most interesting. There are also going to be security issues around fintech that we're going to have to solve. That's an exciting area as well.

Bandwidth and data centers are still big areas because bandwidth is still a constraint in many applications. Now you have only one or two companies controlling your home's internet access, and that's just not going to fly over time. We are involved in a few stocks that could solve the bandwidth issues for both businesses and consumers that are adding optical networks. They are plugging in an area of a city that really needs it—where AT&T, Verizon or Comcast has dropped the ball. There are several companies that have done a good job of filling in an optical network where needed.

Biotech is a bit more murky and misunderstood but has tremen-

dous opportunity. We've started to make some investments there. DNA-related, gene-specific therapy is going to be an exciting area and will change medicine. I have a dedicated person focused on health care and I want to be on top of this when it changes. There's going to be a lot of innovation in this area. Over the long term we think genetic mutation gene therapy is really going to be a huge change.

Bob: How do you think advisors should use this strategy in their clients' asset allocations?

James: In general, I think many investors can benefit from an allocation to emerging growth companies through our fund, particularly in our current slow growth economy where it is hard for larger companies to drive meaningful growth. I also think the fund is good fit as a satellite to a core passive portfolio. Our fund is what I would call an anti passive fund. Over time, we believe we can de-

liver meaningful alpha over a passive allocation.

Bob: What sets this fund apart from others that focus on emerging growth opportunities?

James: The most important thing is my experience level. I've been through the highs, the beginnings of the market in the 1990s, the highly speculative point in the late 1990s, the lows at the bottom in 2002 and then came out of it in the late 2000s and saw the disaster in commodities and home prices. You have a manager who has been through a lot of wars, is still invigorated and still wants to do well for shareholders. On top of that I have 50%-60% of my net worth invested in the fund. I think it's a really compelling opportunity, because you have an experienced manager implementing a high conviction, valuation sensitive strategy seeking to capitalize on the growth of emerging companies that are breaking new ground.

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CAPITAL MANAGEMENT

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Advisor Perspectives

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The Russell 2000 Growth Index is a market capitalization weighted index representing those stocks within the approximately 2000 smallest companies in the universe of U.S. equities that exhibit growth characteristics. This index does not incur expenses, is not available for investment and includes the reinvestment of dividends.

While the fund is no-load, management fees and other expenses still apply. Please refer to the prospectus for more information.

Performance data quoted represents past performance and does not guarantee future results.

One cannot invest directly in an index.

ETFs refers to Exchange-Traded Funds.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

(Over Please)

As of 9/30/2017, the Fund's top ten holdings as a percentage of total assets were:

 Holding 	 % of Total Portfolio
Ligand Pharmaceuticals	3.8
LendingTree Inc.	3.4
Sarepta Therapeutics Inc.	3.1
Planet Fitness Inc. - Class A	3.1
The Trade Desk Inc. - Class A	3.0
Align Technology Inc.	2.9
Bio-Techne Corp.	2.9
Cavco Industries Inc.	2.8
Trex Company Inc.	2.6
Zillow Group Inc. - Class A	2.6

Fund holdings and sector allocations are subject to change and are not recommendations to buy or sell any security. *Current and future holdings are subject to risk.* Further information about the Fund's portfolio allocation as of the last day of the most recent calendar quarter is available by visiting www.osterweis.com.

Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales.

Alpha is a measure of the difference between the portfolio's actual return versus its expected performance, given its level of risk as measured by Beta. It is a measure of the historical movement of a portfolio's performance not explained by movements of the market. It is also referred to as a portfolio's non-systematic return.

Price-to-Earnings (P/E) ratio is the ratio of the stock price to the trailing 12 months diluted EPS.

S&Ls refers to savings and loans.

IPO refers to initial public offering.

Osterweis Capital Management is the adviser to the Osterweis Funds, which are distributed by Quasar Distributors, LLC. [24139]