OSTERWEIS
CAPITAL MANAGEMENT

Investing in Market Disruptors

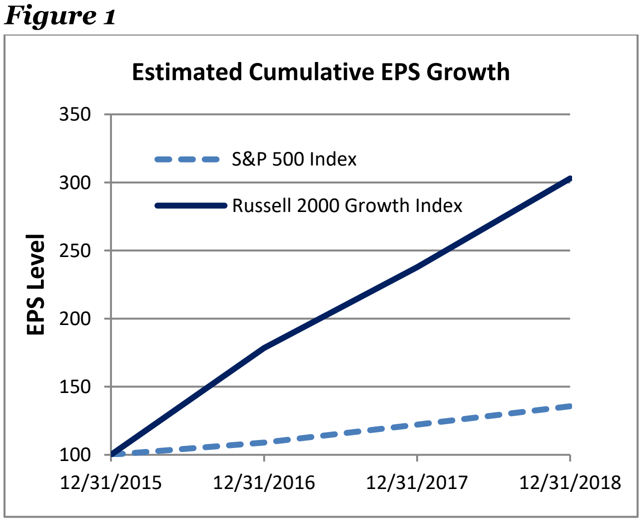
December 2016

For decades, technology has been driving disruptive change in our economy. Long-established, capital-intensive businesses are being upended by fast-growing, innovative and highly profitable competitors. The question for investors is: How can they benefit from the rapid growth of market innovators while trying to manage the risks of investing in somewhat unproven companies?

The Opportunity & Risk

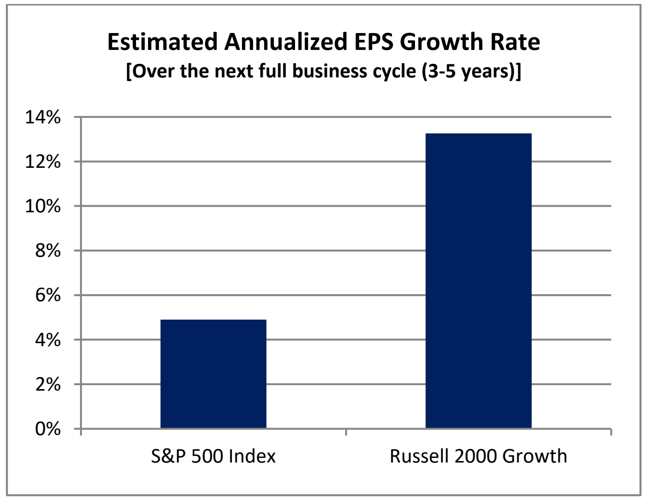
In a slow growth economy, it is challenging for large, established companies to drive meaningful growth. Newer market entrants are breaking ground and have the potential to redefine markets, displace long-established firms and drive attractive earnings growth and margin expansion over time [Figures 1 & 2]. Additionally, smaller companies may benefit from a less restrictive regulatory environment in the coming years.

Figure 1



Source: Bloomberg
Assumes base EPS levels of 100 on 12/31/2015
EPS = Earnings Per Share

Figure 2



Source: Bloomberg

Investing in market-disrupting companies can be quite risky. As we saw in the tech bubble of the late 1990s and eventual bust, many market darlings can quickly become market has-beens. Investor confusion was compounded during this time by the sheer number of newly public companies. Over time, the Amazons and Netflix's separated themselves from the pack. While everyone would like to invest in the next Amazon or Netflix, the challenge is identifying the likely winners and buying them at the right price.

Investing in Emerging Companies

For newer market entrants to survive and thrive in today's environment, they need to position themselves in emerging industries where they have the opportunity to be a disruptive force or focus on defensible niches where they can quickly build their brand and market share. Investing in these companies needs to be more than just a leap of faith. It is important to identify a fundamental reason to own a stock over the long term and have the discipline to stick with it in the face of severe price volatility.

One of the keys to investing in emerging companies is having a disciplined approach to avoid getting caught up in fads or flushed out because of short-term volatility. Ideally, investors should search for undiscovered companies with distinct proprietary advantages that provide for open-ended growth. A familiarity with the venture capital and startup community can be helpful in terms of understanding what types of entrants are coming into markets and where other investors are seeing opportunities. To help identify these potential companies, investors can evaluate the constituents of the Russell 2000 Growth Index based on a number of factors, including:

- Sales growth
- Price to sales ratio
- EBITDA yield
- Margins
- Price momentum

After the potential investment universe is narrowed, investors should focus on companies that appear to be able to deliver 20%+ revenue growth *and* rising margins over the next several years. It is ideal to invest as a company is gaining scale and margins are just starting to rise. Investors need to perform careful research to truly understand the company, its markets, how it is operating, etc. in order to assess if the company's valuation is compelling relative to its projected growth.

Assessing Fundamentals & the Long-Term Opportunity

Investors often question the fundamentals of rapidly growing companies in emerging industries. It may appear that management companies are "feeling their way along" a new and unknown path to profitability and growth. As a consequence, management teams feel compelled to set "stretch" goals that they annually discuss with investors. Investors can use these "stretch" goals to monitor the long-term prospects of a company. To be meaningful in terms of long-term opportunities, these growth goals should be quantifiable and multiples of their present size. The goals must be attainable within 3-5 years and the company must be able to show intermediate progress toward the goal. Importantly, the goal should be achievable with current corporate resources. An investor cannot assume that an acquisition or additional capital raising will drive the expected growth.

These quantifiable growth goals can be translated into projected earnings per share, which can provide some predictability in otherwise often murky (though exciting) future outcome. Then an estimate of the potential upside price target can be established, allowing an investor to evaluate the current price versus the target to help avoid buying into overly valued stocks.

Having a quantifiable growth goal and target price can also help manage risk as money can be taken off the table if a name gets overheated and then later redeployed if the stock comes back into an attractive upside potential range.

Buying Emerging Growth Companies

Given the volatility in the market, it is critical to have a disciplined approach to buying emerging growth companies that is valuation sensitive. Volatility can work toward investors' advantage if they take a disciplined approach to buying the stock when there is significant upside and trimming or selling the stock when that upside diminishes.

Today it appears that investors are much more short-term oriented. This myopic focus can cause near-term issues to dramatically affect a stock's market value. Additionally, hedge funds may be significantly contributing to volatility as they seek the illiquidity and beta of smaller caps as well as the potential to short the "futures-like" quality that many growth stocks attain at certain extremely bullish/overbought times. Hedge funds also relish the leper status that many fallen growth stocks can potentially sink to, creating additional gains for the short side. Consequently, these investor-driven but not fundamentally-driven price degradations may offer ideal entry opportunities.

Moreover, mystery can provide additional price volatility. Many times, when companies first go public, there is a drop from their Initial Public Offering (IPO) price as the markets struggle to understand and gain confidence in the company. This can provide opportunities for disciplined investors who have the capability and prior experience to understand ahead of others the long-term potential of the company.

In other situations, a newly-listed stock can take off for a period of time but then decline back to IPO levels as a consequence of the "reality setting in" period when projected growth may be slower than first thought. This can provide another attractive opportunity to invest in a rapidly growing company (assuming that the company has only had a temporary setback).

Future Areas to Watch

We think there are several areas of the market where upstart companies have the ability to innovate and drive rapid growth over the next five years:

- FinTech – While we all do banking online, banks have been fairly slow adopters of technology. We think innovative companies like Q2 Inc. will aggressively work to disrupt traditional banking models.
- Health Care:
  – Providers: As Baby Boomers continue to age there will be increasing demand for various health care services. This demand is currently supplemented by and not solely dependent on the Affordable Care Act.
  – Medical Devices: With ongoing innovation in this space, we expect to see some game-changing devices being brought to market by niche companies.
  - Biotech – While we think there is significant near-term risk in this area, as it matures, we think that DNA-specific gene therapies are likely to be game changers in the treatment of various diseases.
- Digital Marketing – Companies, such as Lending Tree in the consumer lending business, that help businesses deliver their message in targeted, consumer-friendly ways are expected to fundamentally change how companies go to market with their message.
- Bandwidth and Data Content – Consumers and businesses will continue to need more and cheaper bandwidth as they consume an increasing amount of content on their various devices. Companies that can help meet this need are poised to rapidly gain market share.
- Consumer Internet Services: There are a number of businesses such as Square, Zillow and Yelp that are growing by enabling other business to efficiently distribute their goods and services to consumers.

Disclosure

Earnings growth is not representative of the fund's future performance.

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

EBITDA is an acronym for Earnings Before Interest, Taxes, Depreciation and Amortization. EBITDA yield is a measure of EBITDA to enterprise value.

Price-to-Sales Ratio (P/S) is the ratio of the stock price to the sales per share for a 12 month period.

Beta measures the sensitivity of the stock's price to movements in the stock market.

Past performance is no guarantee of future results. This commentary contains the current opinions of the authors as of the date above which are subject to change at any time. This commentary has been distributed for informational purposes only and is not a recommendation or offer of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed.

The Osterweis Funds are available by prospectus only. The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the Funds. You may obtain a summary or statutory prospectus by calling toll free at (866) 236-0050, or by visiting www.osterweis.com/statpro. Please read the prospectus carefully before investing to ensure the Fund is appropriate for your goals and risk tolerance.

Mutual fund investing involves risk. Principal loss is possible.

The Osterweis Emerging Opportunity Fund may invest in unseasoned companies, which involve additional risks such as abrupt or erratic price movements. The Fund may invest in small and mid-sized companies, which may involve greater volatility than large-sized companies. The Fund may invest in IPOs and unseasoned companies that are in the early stages of their development and may pose more risk compared to more established companies. The Fund may invest in ETFs, which involve risks that do not apply to conventional funds. Higher turnover rates may result in increased transaction costs, which could impact performance. From time to time, the Fund may have concentrated positions in one or more sectors subjecting the Fund to sector emphasis risk. The Fund may invest in foreign and emerging market securities, which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks may increase for emerging markets.

As of 12/31/2017, the Fund's top ten holdings as a percentage of total assets were:

Holding	% of Total Portfolio
Bio-Techne Corp.	3.6
Planet Fitness Inc. - Class A	3.4
GTT Communications Inc.	3.3
LendingTree Inc.	3.1
Etsy Inc.	3.1
Ligand Pharmaceuticals	3.1
Orasure Technologies Inc.	3.0
Kratos Defense & Security	2.9
Sarepta Therapeutics Inc.	2.8
Nutanix Inc - Class A	2.8

Holdings may change at any time due to ongoing portfolio management. References to specific investments should not be construed as a recommendation to buy or sell the securities. Current and future holdings are subject to risk.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

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.

These indices do not incur expenses, are not available for investment and include the reinvestment of dividends.

One cannot invest directly in an index.

Osterweis Capital Management is the adviser to the Osterweis Funds, which are distributed by Quasar Distributors, LLC. [24060]