TRAN CAPITAL MANAGEMENT

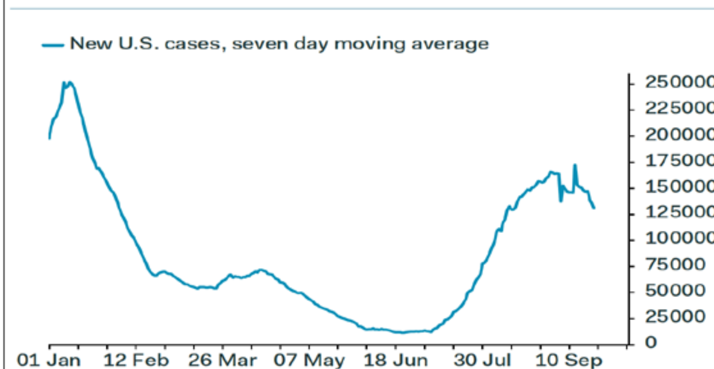
Multi-Cap Growth Equity | Third Quarter 2021

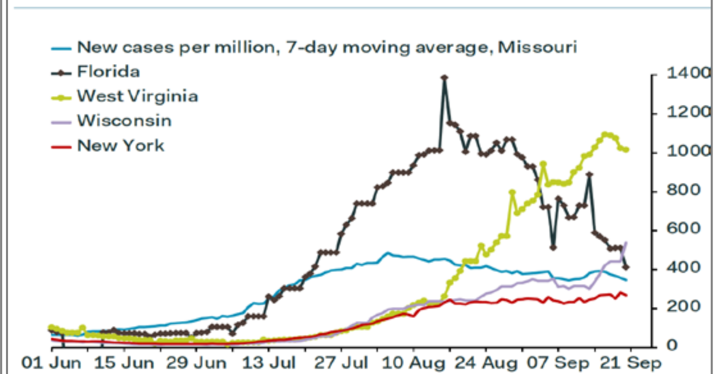
Dear Clients,

We hope you had a great summer and are enjoying the start of fall. This is one of our favorite times of the year where we reflect on our past achievements and position the portfolio for the next few years. We are happy to report that the portfolio had a strong third quarter. **For the quarter, our portfolio generated returns of 3.3%, net of fees, vs. the S&P 500's return of 0.6%. This brings our year-to-date total return to 18.8%, net of fees, vs. the market's return of 15.9% and our three-year returns to 19.0%, net of fees, vs. the market's return of 16.0%.** We are grateful to be able to generate these returns for you and continue to search for the best opportunities for the prospective 3-5 years.

As we evaluate the health of the U.S. economy and narrow our focus on the best investment opportunities for our clients, we observe that concerns over the Delta variant and inflation permeate the financial press. These concerns are real, but only time will tell how much these risks will impact the stock market and our portfolio companies. We seek to mitigate these risks by investing in companies that are backed by strong secular growth stories, have products and services with pricing power to offset rising input costs, and are run by management teams with exceptional capital allocation track records.

Fortunately, we see signs that may be very constructive for the economy and our investments. The Delta variant's emergence in the U.S. has caused parts of the economy to slow. However, recent data suggests that infections may have peaked in September and are now falling. If these trends continue, we expect an easing in COVID restrictions and the economy to pick up speed in the fourth quarter and into 2022.

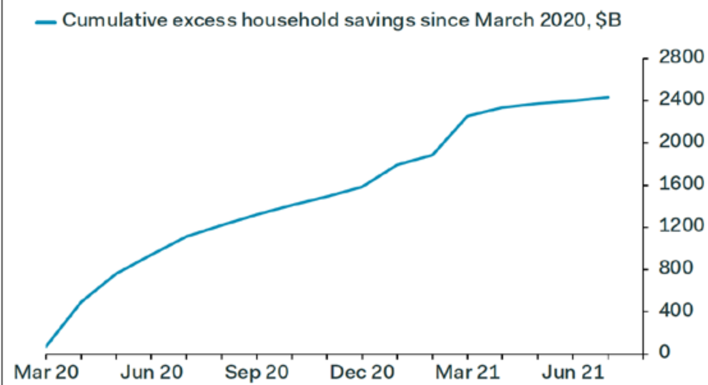


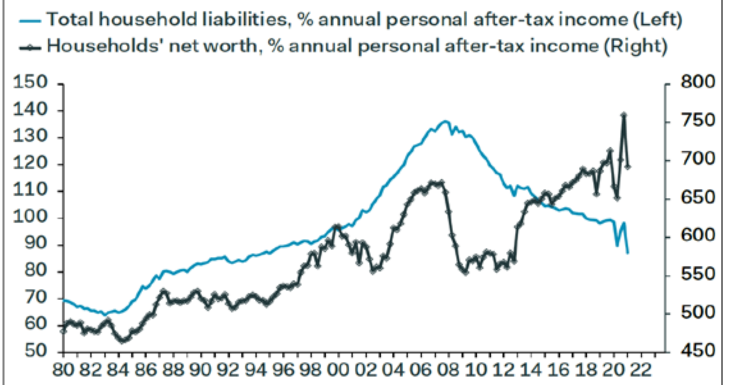


Source: Pantheon Macroeconomics, September 2021

Our confidence is further bolstered by the health of consumers and business balance sheets, which are in good shape. While the COVID induced restrictions have limited our travel and activity over the past 18 months, one of the positive impacts over the past year is that household savings have increased. According to the Bureau of Economic Analysis, **U.S. households have amassed $2.4 trillion in excess**

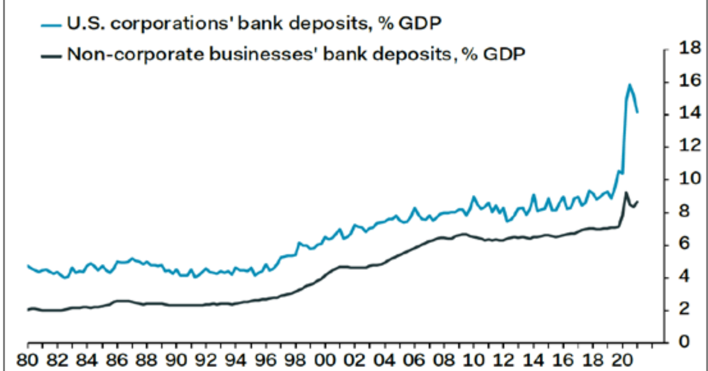
savings since March 2020. Moreover, household liabilities as a percentage of income are now lower than any point over the past decade. This is particularly noteworthy because consumers spending represents about two-thirds of U.S. GDP.

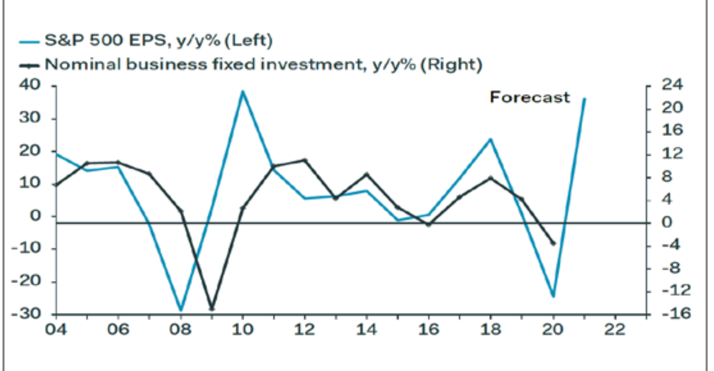


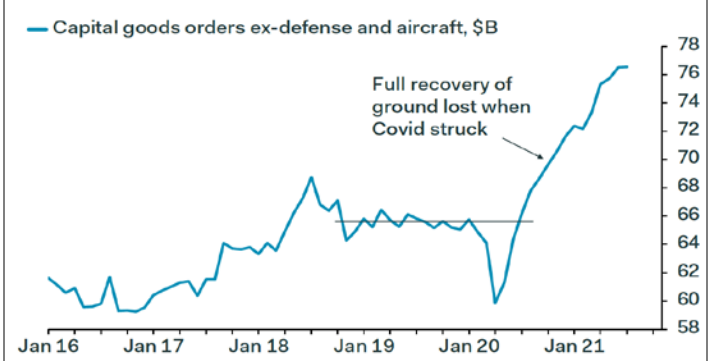


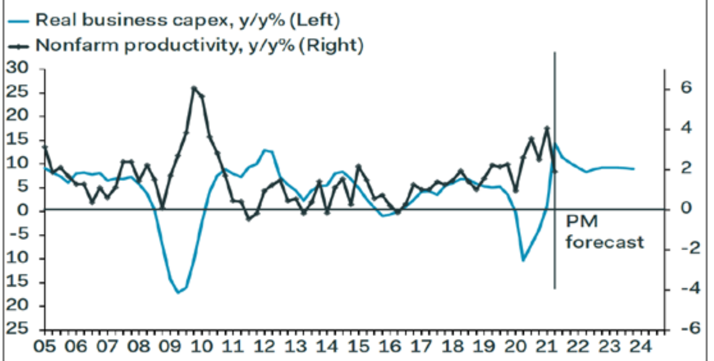
Source: Pantheon Macroeconomics, September 2021

Much like households accumulated savings, business balance sheets have also strengthened. Bank deposits by U.S. corporation and non-corporations as a percentage of GDP are near record highs. Meanwhile, corporate earnings have been strong and are forecasted to grow over 20% in 2021. Flush with cash and facing supply issues, businesses are deploying capital towards buying capital equipment. **History has shown that when capital investment occurs, growth and productivity follow. We saw a material increase in capital investments from 2020 to 2021**.









Source: Pantheon Macroeconomics, September 2021

Portfolio Positioning

Our portfolio is constructed with investments that have sustainable growth profiles. These companies are led by management teams who have been tested and have a great history when it comes to capital allocation. We have a significant allocation to companies that enable and benefit from digital transformation of the workplace, such as the continued shift of enterprises to cloud and hybrid working environments. **Alphabet (GOOGL)**, **Microsoft (MSFT)**, **Palo Alto Networks (PANW)**, and **Salesforce (CRM)** all provide essential software and tools that enable enterprises to securely work at home, in the office, or in a hybrid setting. We believe the competitive advantages for these companies only strengthened during the pandemic and continue to hold our positions.

In addition to our core positions, we would like to highlight a few investments that we find particularly timely. The semiconductor shortages have had an impact on many industries, including the automotive sector's production and dealer inventory levels. We believe this is a temporary problem that should be resolved in one or two years. One company that we find attractive is **Lithia Motors (LAD)**. Lithia is a leading automotive retailer in North America. This is a highly fragmented market and although Lithia owns over 265 dealerships, the company only commands ~2% market share. High consumer savings should mean continued strong demand for vehicle sales despite the recent weakness in new and used auto sales, which we view to be the result of supply shortages as opposed to demand destruction. **In our outlook, we believe demand for autos outstrips supply, supporting a multi-year industry growth in units sold.**

Outside of its physical dealerships, Lithia is also building out its "Driveway" e-commerce platform. To do so, Lithia is conducting a series of tuck-in acquisitions to expand its geographic footprint, getting inventory close to the consumer. We view Lithia management to be adept at making and integrating these dealerships. Today, customers can search, finance, and complete their automotive purchases online and have vehicles delivered to their home. We believe a national e-commerce auto retailer will have advantages over brick and mortar due to (1) a user-friendly and transparent buying experience that reduces friction around financing and affordability, (2) enhanced inventory selection on regional/national level, and (3) efficient marketing channels with a recognized national brand. **Today, e-commerce sales for used autos is <2% penetrated; we believe Driveway has an opportunity to be a major player in the next-gen auto retail experience.** Our research suggests that Lithia's earnings will grow from approximately $33 per share in 2021 to over $50 per share by 2025 before potential upside from Lithia building out its in-house financing arm as well as at-home servicing of cars, neither of which are included in our estimates. At around $315 per share, Lithia is trading at 10x 2021 P/E. We believe the market is overly concerned about short-term auto supply constraints and underappreciating Lithia's long-term growth potential.

We would also like to highlight **Clarivate (CLVT)**, a leading healthcare and research database company. Longtime clients may remember that Clarivate is not a new company for us. We often find great opportunities from corporate spinouts. Our experience has shown that these companies may be under-followed and often have growth stories that take some time for investors to appreciate. Clarivate was spun out of Thomson Reuters in 2016 and became a public company in 2019. We originally believed that Clarivate's highly recurring and free cash flow generative business model would allow the company to reinvest to improve their mission critical core databases and business intelligence solutions while also making value-enhancing M&A to bolster their offerings. Clarivate's management team did a wonderful job and doubled our initial investment in two years until we exited our position in January 2021. Since we sold our position, Clarivate missed estimates on core growth (due to customer renewal delays) and made an unexpected acquisition of ProQuest, LLC. Clarivate stock subsequently fell about ~30% from our sale price.

This drawdown prompted us to revisit the company. After analyzing the reasons for Clarivate's share price weakness and updating our assumptions, we believe the recent pullback represents an attractive entry point. **Clarivate's subscription business model means that approximate ~83% of its revenues are subscription-based or recurring which gives us confidence in our long-term projections**. Additionally, incremental revenues are highly profitable and free cash flow generative given low incremental investment needs. Finally,

Clarivate has a demonstrated history of integration and execution with acquisitions. Thus, we believe Clarivate's recent acquisition enhances the company's value by expanding its addressable market and we are delighted to own the stock once again.

Finally, we also sold **Twitter (TWTR)** to fund more attractive opportunities. Twitter was purchased during the first quarter of 2020 on our belief that the company could improve governance, launch new products, and have a more thoughtful capital allocation strategy. Twitter has shown improvements in all these areas and the stock has appreciated over 100% from our initial lots. At our sale price of approximately $70, Twitter was selling at over 70x 2021 estimated earnings. We believe this valuation reflects most of our growth assumptions and decided to reallocate that capital to other ideas that were underappreciated.

Looking Forward

We are grateful to produce strong results for our clients. As we look forward, we are monitoring risks like the Delta variant, inflation, geopolitical tensions, and other macro factors. However, we see a healthy consumer and business backdrop within the U.S. and an attractive trajectory for corporate earnings growth. Most importantly, we believe we have constructed a portfolio of strong and improving businesses that should produce a sustainable growth profile for our portfolio. Thank you for your trust in us. If you have any questions, please give us a call or visit us!

Sincerely,

Quoc K. Tran
Chairman & CIO

Michael Im
Co-Portfolio Manager & Director of Research

Eric A. Winterhalter
President

Important Disclosures

Past performance is not indicative of future results. The actual return and value of an account will fluctuate and at any point in time could be worth more or less than the amount initially invested.

Performance is provided as supplemental information and is based on the Non-Taxable Multi-Cap Growth Equity Composite. Performance results reflect all income, gains and losses and the reinvestment of interest and other income. All rates of return are reported "NET" of fees. Additional information regarding the policies for calculating and reporting returns is available upon request. A complete listing and description of all TCM composites and performance results is available upon request.

The 1-year, 3-year, 5-year and 10-year net of fees returns of the Non-Taxable Multi-Cap Growth Equity Composite as of September 30, 2021 are 38.97, 18.98, 16.99 and 15.43 respectively. The 1-year, 3-year, 5-year and 10-year returns of the S&P 500® Index as of September 30, 2021 are 30.01, 15.99, 16.90 and 16.63 respectively. 3-year, 5-year and 10-year performance figures are annualized.

The S&P 500® is an unmanaged stock market index and is not available for direct investment. The S&P 500® Index represents the stocks of 500 leading U.S. publicly-traded companies from a broad range of industries. The performance of an unmanaged index reflects no deductions for fees, expenses or taxes which would affect performance of actively managed assets. The volatility of the S&P 500® Index may be greater or less than the volatility of the portfolios in the composite.

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