TRAN CAPITAL MANAGEMENT

Multi-Cap Growth Equity | Second Quarter 2022

Dear Clients and Friends,

We hope you and your family are well. The second quarter of this year experienced continued selling pressure with the S&P 500 returning -16.11%, bringing YTD return down to -20.0%. Investor concerns were dominated by potential economic consequences from the Federal Reserve's recent and planned rate hikes to battle inflation along with Russia's continued invasion of Ukraine. This volatile environment led to indiscriminate declines in the valuation multiples of most stocks, especially for longer duration growth companies. For the quarter, our Multi-Cap Strategy returned -19.92%, net of fees. The broader market returns across most asset classes were also disappointing.

Index	Return (2Q 2022)	Return (1H 2022)
S&P 500	-16.11%	-19.97%
NASDAQ Composite	-22.27%	-29.22%
Russell 2000	-17.21%	-23.45%
Bloomberg U.S. Aggregate Bond Index	-4.69%	-10.35%
Bloomberg U.S. Corporate Bond Index	-7.26%	-14.39%
iShares 20+ Year Treasury Bond ETF	-12.59%	-21.88%

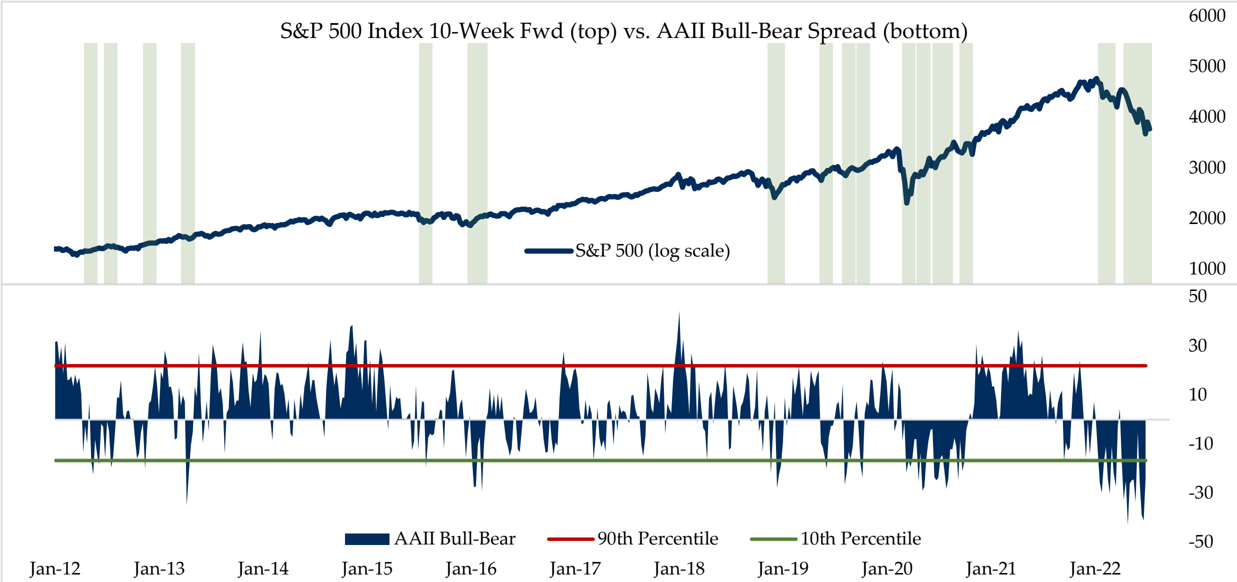
The start of 2022 has been a historically bad. In fact, through June 17th – the low point of the year thus far – this has been the worst start since the Great Depression. The chart below illustrates the ten worse starts for the S&P 500 over the past century. While these market declines are painful to say the least, historically, the subsequent returns have been strong. Moreover, we believe that our portfolio companies are successfully navigating these volatile times. Our research finds that our companies continue to generate strong revenue and earnings growth, and we believe these companies will emerge from this period of disruption stronger. ***This is why investing in leading companies with high recurring revenues is at the core of how we invest. While stock prices may be down, we believe intrinsic values are growing.***

Worst Start after Great Depression in ~100 Years

#	Year	Events	YTD as 6/17	6/17 to YE
1	1932	Great Depression	-40.5%	43.3%
2	2022	Current	-22.9%	?
3	1962	Kennedy Slide	-21.9%	12.9%
4	1940	World War II	-19.9%	6.0%
5	1970	Vietnam War/Tightening	-17.4%	21.3%
6	1939	World War II	-14.2%	10.5%
7	1982	Oil Crisis	-12.2%	30.7%
8	1931	Great Depression	-11.9%	-39.9%
9	1973	Oil Shock	-11.0%	-7.2%
10	1937	Fiscal & Monetary Contraction	-10.4%	-31.4%

Source: Bloomberg

We want to acknowledge that the market and economic stresses are real. Prices for food, gas, and housing are high and hurting every household. Not surprisingly, investor sentiment is currently among the lowest in decades. Importantly, when investor sentiment is at bearish extremes, it often makes sense not to panic as market turns can be quick and powerful. The chart on the next page plots the S&P 500 against the spread between the American Association of Individual Investors' Bullish and Bearish Readings. As you can see, points of extreme bullishness (peaks) or bearishness (troughs) often coincide with inflections in the market.



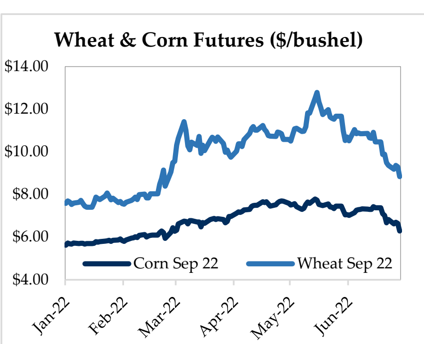
Source: Bloomberg

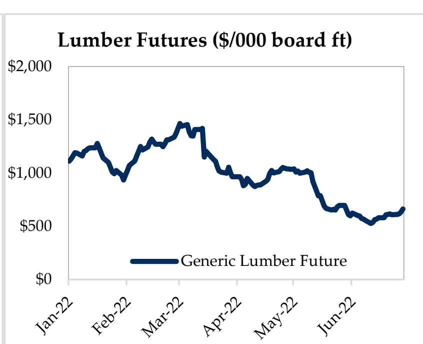
What happens from here? We would like to share some thoughts.

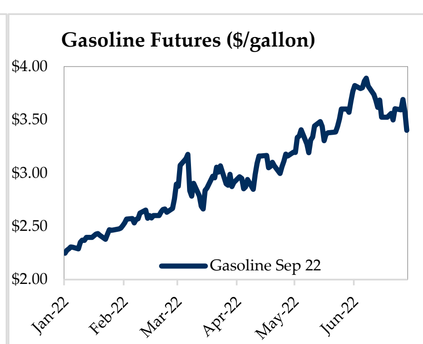
First, despite continued strong underlying results from our companies, valuations have been cut dramatically. This was driven by the Fed's hawkish pivot over the past 6 months to combat inflation, which has been both faster and more aggressive than the market had anticipated. At the start of 4th quarter 2021, Fed Fund Futures were pricing in just one 25 bps rate hike for all of 2022, for an implied year-end 2022 rate of 0.3%. Today, the futures market sees the year-end rate at 3.375%. We believe that the worst is likely over and that the increase in rate expectations is now mostly embedded in market expectations as the Fed has changed its rhetoric and laid out a clear plan for rate increases going forward. In other words, after hiking its target rate 150 bps over three meetings through June, the Fed is planning another 175 bps by year end. Unlike the beginning of 2022, the market has now baked in much higher interest rate increase expectations.

The impact of the Fed's actions includes higher interest rates for mortgages, auto loans, and financing for other major purchases. We are starting to see a decline in demand for mortgages, auto loans, and other goods, which should help improve current supply and demand imbalances.

Second, although inflation remains elevated, we are seeing early signs of moderation. Housing, food, and energy will take time to moderate, but the trend may be heading down. Since peaking in mid-May, corn and wheat futures have declined ~19% and ~29%, respectively. Lumber futures have declined ~55% since peaking in early March. While gasoline prices remain high, the rate of increase continues to decelerate, and we note that historically high gas prices have tended to reduce miles driven. While current at-the-pump prices remain high and burdensome, gasoline futures have come down in recent weeks as well.

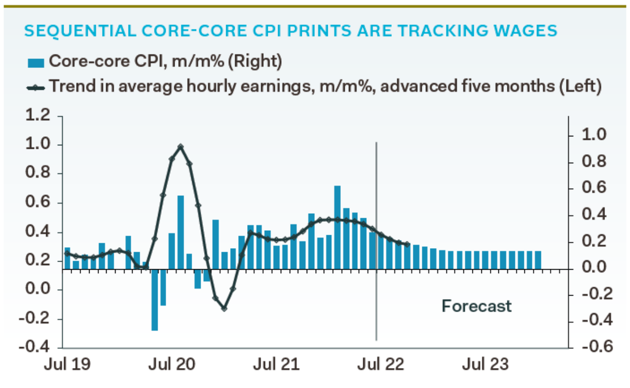


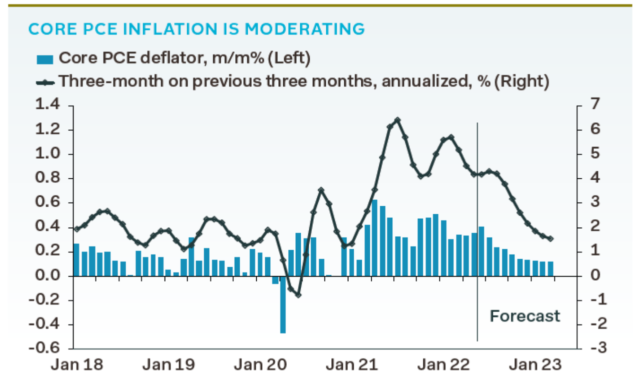




Source: Bloomberg

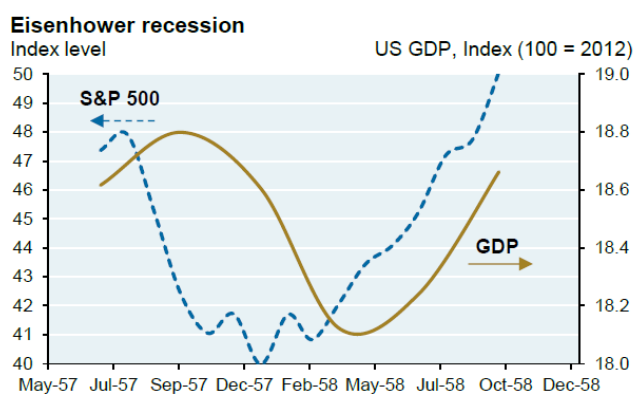
CPI remains top of mind as a gauge of inflation. Housing costs and rents make up nearly 1/3 of CPI, we believe that the continued deceleration in month-over-month hourly wage growth can help alleviate high housing costs over time (bottom left). As supply chains unwind, aided by a reopening in China, we believe car production will ramp toward historical norms, putting downward pressure on new and used car prices as well (with volume growth also aiding **Aptiv** and **Lithia Motors).** As shown below, Core CPI is forecasted to start declining this fall and into 2023. Additionally, the ISM's Manufacturing PMI, an important metric monitored by the Fed, has been declining since March. We believe it will take some time, but inflation seems to be moderating.

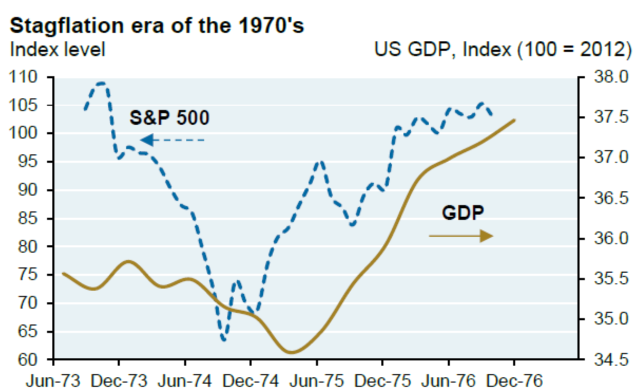


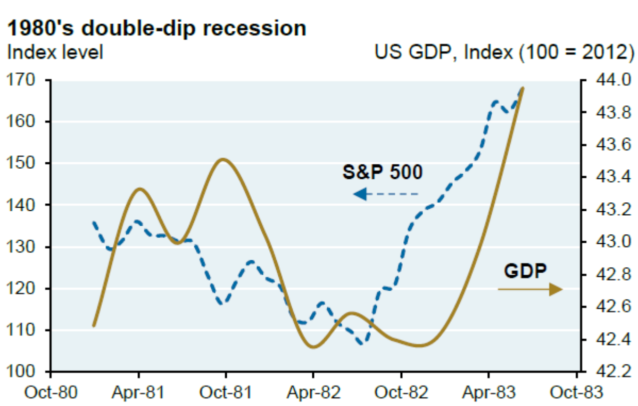


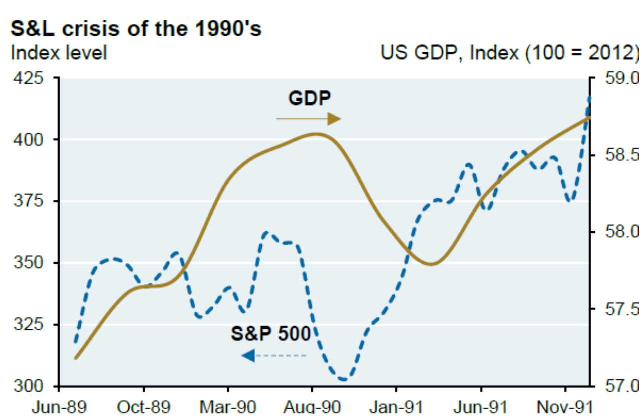
Source: Pantheon Macroeconomics

Third, while no one knows when the market bottoms until after it has happened, history shows that equity markets decline and bottom ***before*** economic data bottoms. In other words, by the time experts declare that we are in a recession, we are already on our way out of it. The charts below and on the following page depict prior major post-war business cycle drawdowns that support the observation that the market bottoms before GDP bottoms.

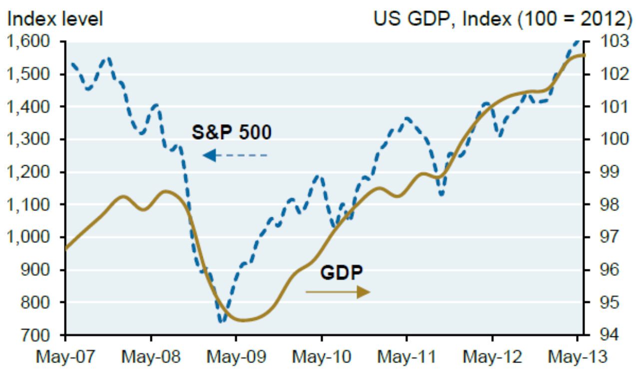


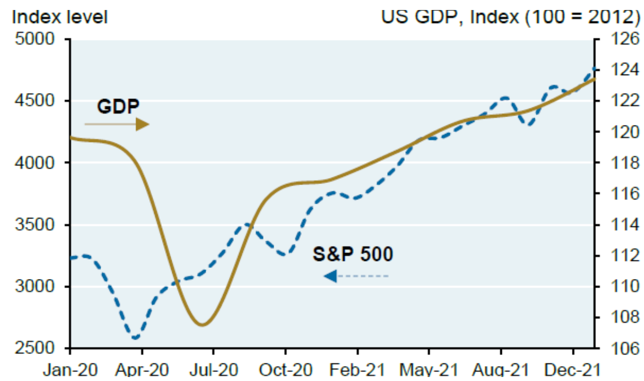






Source: BEA, Bloomberg, JP Morgan Asset Management





Source: BEA, Bloomberg, JP Morgan Asset Management

Fourth, in practically every bear market, the S&P 500 was up significantly over the subsequent period.

Fifth, while macro factors like inflation, interest rates, and geopolitical conflicts have buffeted the stock market, we invest in companies with strong moats and above market growth. Our portfolio is a collection of leading businesses that provide essential services and products that we believe have many years of growth ahead.

The valuation of our investments has declined to levels ***lower*** than at the start of the pandemic. This is particularly noteworthy because we believe our portfolio companies generate higher growth, earn higher returns on equity, and sell at lower valuations than the overall market. The following table compares P/E multiples for our portfolio companies in February 2020 versus June 2022. As you can see, over 90% of our companies are trading at valuation levels that are lower now than before the pandemic.

The valuation compression has been much more severe than we expected. We believe our portfolio companies continue to navigate this environment with robust revenue and earnings growth. In general, our companies are raising prices when appropriate, cutting costs, and using free cash flow to reinvest in their businesses, make acquisitions, and buy back stock. We believe these actions will enhance shareholder value. Historically, we've seen our companies emerge from difficult economic conditions stronger as they typically gain market share during periods of disruptions. We expect that this time will be no different.

	CY2 P/E		
	Pre-covid	Current	Diff %
CLVT	28.2x	12.9x	-54.2%
SQ	64.5x	35.6x	-44.8%
CRM	48.5x	27.8x	-42.6%
SBNY	11.2x	6.6x	-40.8%
LAD	10.4x	6.3x	-39.2%
DIS	22.6x	15.2x	-32.9%
SMG	21.9x	15.4x	-29.8%
GOOGL	19.4x	13.9x	-28.5%
BALL	21.8x	15.6x	-28.5%
WFC	10.2x	7.3x	-28.4%
SIVB	11.6x	8.3x	-28.2%
AMZN	37.3x	27.2x	-27.0%

	CY2 P/E		
	Pre-covid	Current	Diff %
HALO	18.6x	13.9x	-25.6%
AER	7.8x	6.2x	-20.8%
MLM	20.2x	16.3x	-19.4%
CTLT	26.3x	22.5x	-14.5%
MSFT	25.2x	21.8x	-13.6%
DHR	26.3x	23.1x	-12.2%
APTV	14.8x	13.4x	-9.1%
IQV	19.2x	17.8x	-7.2%
SHW	21.1x	20.3x	-3.8%
BKR	13.4x	15.8x	17.4%
PANW	36.2x	47.5x	31.2%
Average	**23.3x**	**17.9x**	**-23.5%**
Median	**21.1x**	**15.6x**	**-25.9%**
S&P	**18.4x**	**16.5x**	**-10.5%**

% of stocks below pre-covid valuation	**91.3%**

Note: Sorted by CY2 P/E Diff %

Pre-covid date: 2/1/2020

Portfolio Positioning

We have invested about **1/3 of our portfolio in leading technology companies**. These companies provide essential tools and software that improve productivity, protect enterprises from outside threats, and help grow client revenues. For instance, **Palo Alto Networks (PANW)** is a leading network security company that grew revenue and earnings over 25% in 2021 and is expected to grow revenues and earnings over 20% in each of the next three years. During their May 19, 2022 earnings call, management was asked if they were seeing customers reduce spending in this environment, to which CEO Nikesh Arora answered:

"Look, interesting, if you compare and contrast what we're seeing today with what we saw two and half years ago, two years ago when the pandemic hit, believe it or not, there were more industries impacted by the pandemic than are impacted right now by inflation concerns. The oil industry is not stressing about IT budgets. The commodity industry is not stressing about IT budgets. The CPG industry is not stressing about IT budgets. The tech industry is not worried about IT budgets."

This is a good example of investing in a company that provides an essential service that should grow through uncertain macro conditions. Demand for cybersecurity is higher now than two years ago, and Palo Alto's business has more visibility now than two years ago as well.

We have another **1/4 of our portfolio in healthcare & life science tools and services**. These companies provide essential services to global biotech and pharmaceutical companies where high demand for their services along with protection for intellectual property rights often lead to our companies enjoying multi-year contracts with their customers. In other words, they provide investors with highly visible and predictable revenue streams.

One investment we'd like to highlight is **Halozyme Therapeutics (HALO)**. Halozyme is a leading biopharmaceutical company whose proprietary drug delivery technology enables pharmaceutical companies to change the delivery of their therapies from an intravenous drip to subcutaneous injections. This saves patients time during drug administration (from hours to minutes), creates new intellectual property (patents) for Halozyme's partners (thereby preserving and growing their customers' revenue), and enables Halozyme to earn long-term contractual royalty payments. We estimate that Halozyme's revenue and earnings have the potential to compound at over 20% for the next three years. This stable cash flow generation along with a capital-light business model, will allow Halozyme to deploy free cash flow towards buybacks and accretive acquisitions. Earlier this year, Halozyme announced the acquisition of Antares Pharma, which makes auto injection technology used in devices like the EpiPen. This delivery platform should expand Halozyme's addressable market and enable cross selling between their two client bases. We support Halozyme's acquisition, and our analysis suggests that it is immediately accretive to Halozyme's earnings. We look forward to further developments at Halozyme.

While rising interest rates have led to lower valuation multiples, we have invested about **15% of our portfolio in companies that should benefit from rising interest rates**. One such example is **Wells Fargo (WFC)**, which we first purchased in November 2020. As one of the most asset sensitive large-cap banks, we believed Wells Fargo would benefit from a higher rate environment. More importantly, Wells Fargo also has many potential levers to unlock value after taking numerous steps to righten the business following the consumer account scandal in 2016. We believe the bank has taken the necessary steps to strengthen compliance, has right-sized the business through cost cuts, and can return excess capital to shareholders in the form of dividends and buybacks. As interest rates continue to rise, Wells Fargo will earn higher net interest income, which flows directly into bottom-line earnings and returns on equity. CFO Michael Santomassimo commented on their April 14, 2022 earnings call:

"The rate increases currently in the forward rate curve would also drive stronger net interest income growth than we anticipated earlier in the year….Higher rates will also have a negative impact on mortgage volumes and potentially on market-related fees in corporate and investment banking, and venture capital business, and in wealth management."

While the rapid increase in interest rates will have some negative impact on loan growth and capital market fees, we believe that Wells Fargo will nevertheless remain a net beneficiary of higher rates. Additionally, at 10x 2022 estimated earnings and at a discount to its book value, we believe Wells Fargo continues to be priced attractively.

While most of our portfolio companies have been able to raise prices to off-set inflation, some have been less successful. For instance, **Scotts Miracle-Gro (SMG)**, the leading consumer lawn and garden fertilizer, gardening, and seed company had mixed results as commodity input costs continued to rise after announced price increases for the spring season. CEO Jim Hagedorn shared on their May 3, 2022 earnings call:

"Our pricing strategy initially accomplished what we set out to do, which is cover higher input costs. However, resurgent commodity prices after the start of the war in Ukraine added further downward pressure we couldn't cover."

While we are disappointed in Scotts Miracle-Gro's short-term stumble, we are being patient to see how the company adjusts and performs in subsequent quarters. Excess retail inventories were a headwind this season but sell-through data suggests that future demand will be resilient and strong given the step-up in home ownership and favorable demographics.

Looking Forward

The market correction has taken down almost every sector in the market. This has been difficult to witness and manage. However, as we check in with our portfolio companies and analyze their ability to manage through this period of higher inflation and interest rates, our conviction has only strengthened. We invest in companies who are leaders in their industry and whose products and services are often essential. We believe characteristics result in a high degree of recurring revenue and earnings visibility. Additionally, our companies can raise prices and cut costs when appropriate.

As inflation moderates and interest rate increases become largely embedded into market expectations, we believe fundamental metrics like revenue, earnings, and return on capital will once again be the factors that drive stock price returns. It is on these fundamental factors that give us confidence that our portfolio companies may continue to increase shareholder value over time.

These are volatile times, and we sincerely appreciate your trust and patience. If you have any questions, please do not hesitate to contact us at (415) 461-3800. Thank you for support. We will continue to work hard to navigate these markets.

Sincerely,

Quoc K. Tran
Chairman & CIO

Michael Im
Co-Portfolio Manager & Director of Research

Eric A. Winterhalter
President

Important Disclosure

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 June 30, 2022 are -23.38, 6.20, 8.26 and 9.72 respectively. The 1-year, 3-year, 5-year and 10-year returns of the S&P 500® Index as of June 30, 2022 are -10.60, 10.60, 11.31 and 12.96 respectively. 3-year, 5-year and 10-year performance figures are annualized.

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