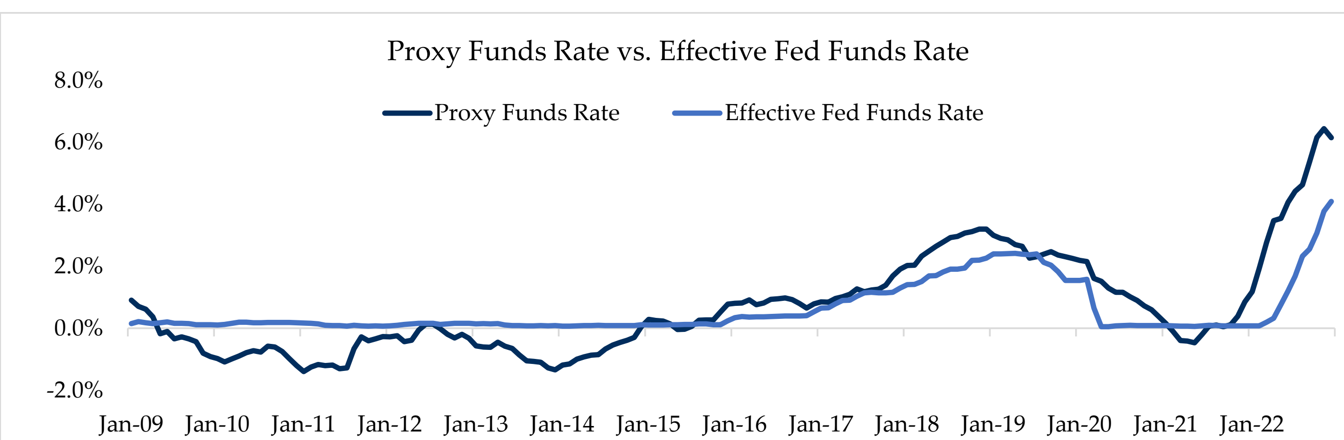
TRAN CAPITAL MANAGEMENT

Multi-Cap Growth | Fourth Quarter 2022

Dear Clients and Friends,

We hope you and your family are well and wish you a Happy New Year. After more than a decade-long bull market run, the markets and our portfolio experienced a significant pullback driven by a valuation reset caused by the Federal Reserve's aggressive interest rate actions and some inconsistent execution from our portfolio companies. For 2022, our Multi-Cap Growth Strategy returned -33.25%, net of fees, compared to the S&P 500 Index return of -18.1%. While we are disappointed in the portfolio's relative return and price performance, we are confident in the fundamentals of our portfolio companies and believe they are well-positioned to outperform when the market rebounds. As we reflect on this challenging past year and lessons learned, we are reminded that during periods of large drawdowns, our three-step process of reevaluating our positions, making appropriate adjustments, and hunting for other great businesses has served our clients well over the long run. **We believe this time is no different. It is precisely during these ugly market corrections that the seeds of future returns are planted.** We are optimistic that the current and ongoing economic backdrop will enable better investment returns. More importantly, we are encouraged by the fundamental strength of our portfolio companies, many of which are trading at multiyear low valuations.

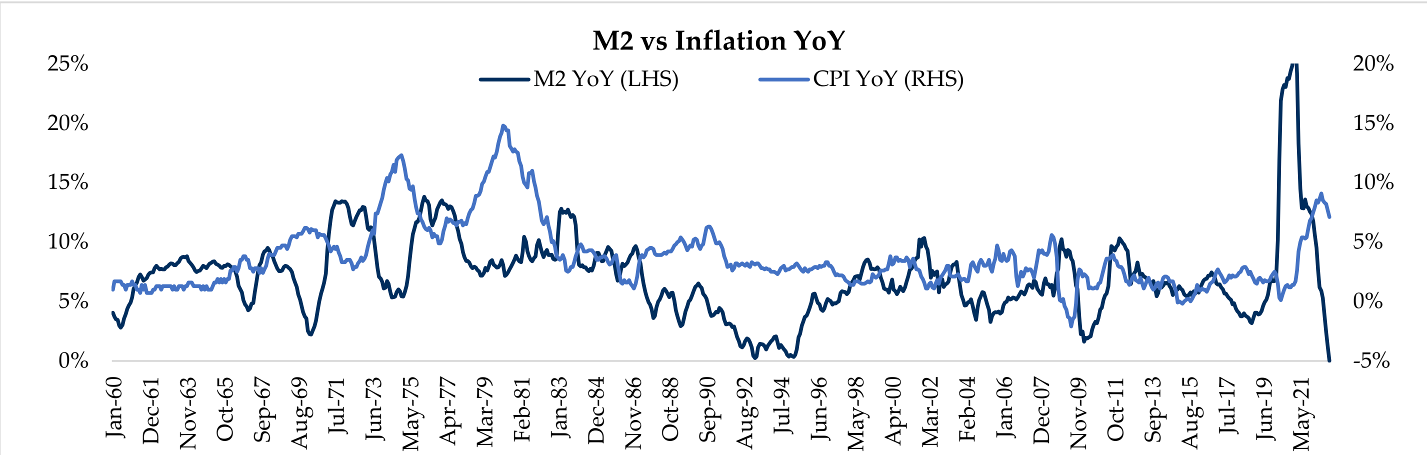
As we've written in prior letters, the Fed raised interest rates more than what we and the market expected in 2022. After a long period of benign inflation, inflation spiked due to a combination of loose monetary and fiscal policies, supply chain disruptions, and Russia's war on Ukraine. We view that many inflationary pressures have peaked and that the current rate tightening cycle may be nearing an end. Financial conditions have already tightened significantly. Currently, the upper bound of the Fed Funds Rate is at 4.50% with the Fed Board Members forecasting a median rate of 5.25% at the end of this year. Further, the Federal Reserve Bank of San Francisco calculates a Proxy Funds Rates that incorporates a set of twelve financial variables to infer actual financial conditions. This Proxy Funds Rate of 6.2% today considers the effects of Quantitative Tightening as the Fed reduces its balance sheet, which we believe makes it a more accurate reflection of rates impacting the economy. At these levels, rates may already be sufficiently restrictive, especially when considering the normal lag in impact from prior rate hikes and cooling inflation. Taken together, the economy could soften faster than the Fed thinks, lessening the need for further hikes. While we cannot time exactly when this will shift, we do know that eventually fundamental factors will again be the driving force behind equity returns.



Source: The Federal Reserve Bank of San Francisco

Signs of Cooling Inflation

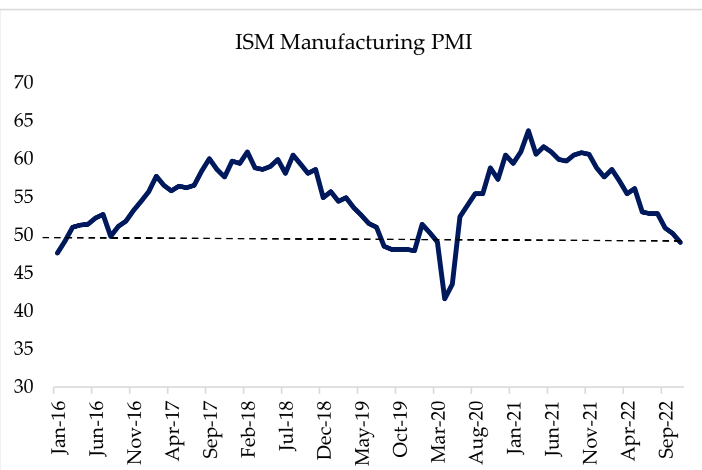
M2 is an economic measure of changes in the money supply. Changes in the M2 have historically led changes in the Consumer Price Index (CPI) by 12-to-18 months. During COVID-19, the U.S. government injected hundreds of billions of dollars to support businesses and families as the economy shut down. As such, M2 growth peaked in February 2021 at +27% year-over-year. Not surprisingly, CPI growth spiked about a year later. Fortunately, M2 growth has been steadily declining and recently became negative. We believe CPI growth will again follow the M2 and decline. With this, the Fed will face less pressure on inflation, allowing for a shift away from today's hawkish tone.

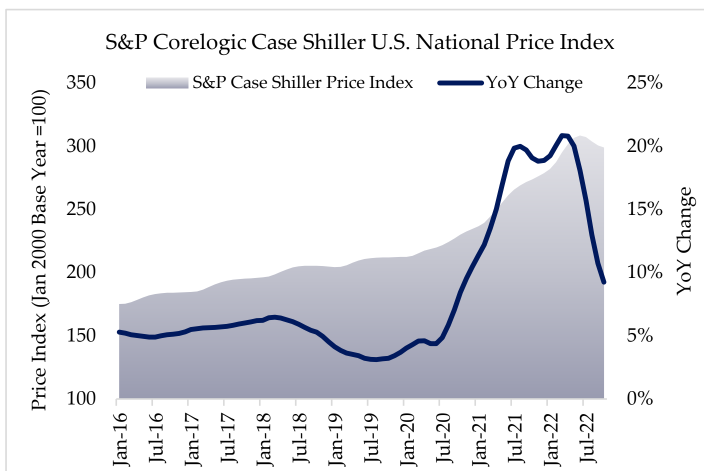


Source: The Federal Reserve Bank of St. Louis, Bloomberg

Outside of the M2-CPI relationship, components within the CPI are turning favorable as well. As indicated by the ISM Manufacturing PMI, consumer demand for products has been fading due to the Fed's rate actions. PMI is a monthly survey that tracks the general state of manufacturing economy. As shown below, PMI peaked in 2021 and has fallen to below 50 today, indicating a contracting manufacturing economy and dampening consumer demand for goods.

Housing, or owner's equivalent rent, is the largest component of CPI. Higher rates have caused interest rate sensitive sectors such as housing to cool. The rate on 30-year mortgages has more than doubled to over 6.5%, which has reduced housing demand and affordability. The S&P CoreLogic Case-Shiller Index tracks the value of single-family homes in the U.S. As shown in the bottom right chart, the year-over-year pace of home value increases has inflected and turned sharply downward ever since the Feds started raising rates.

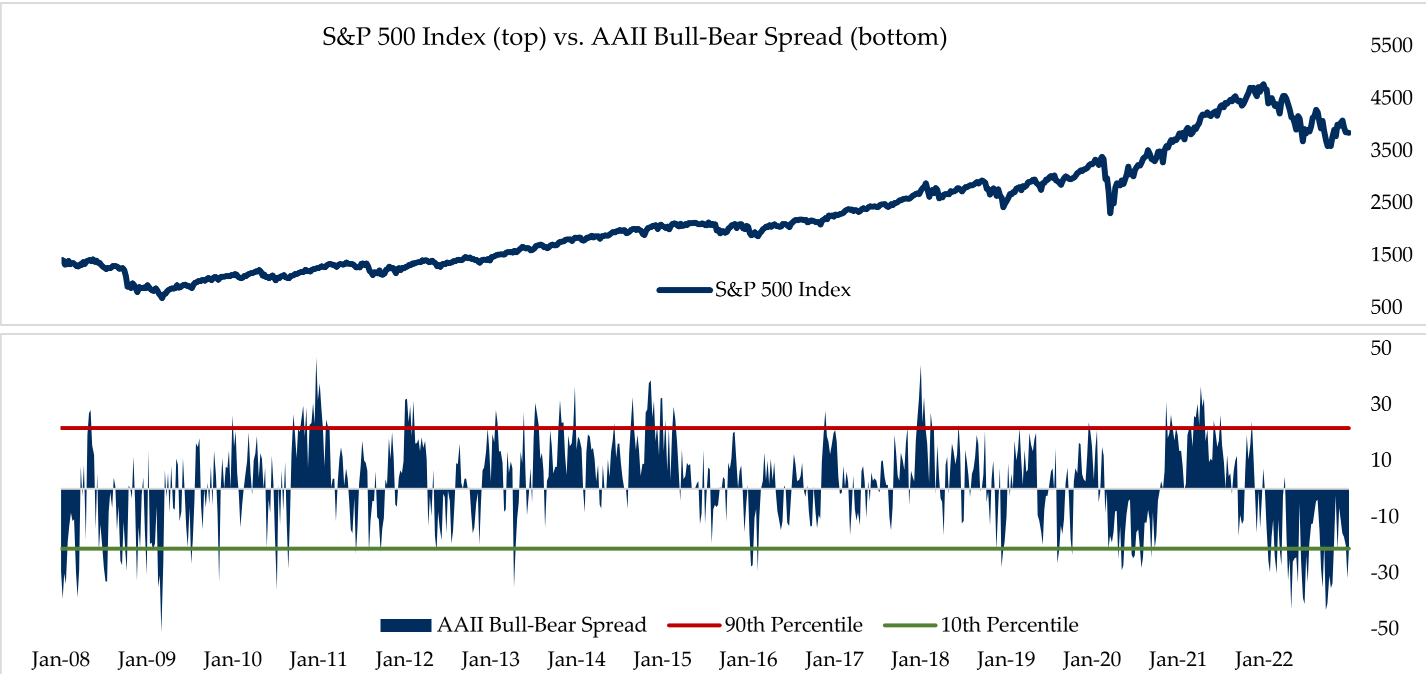




Source: Bloomberg

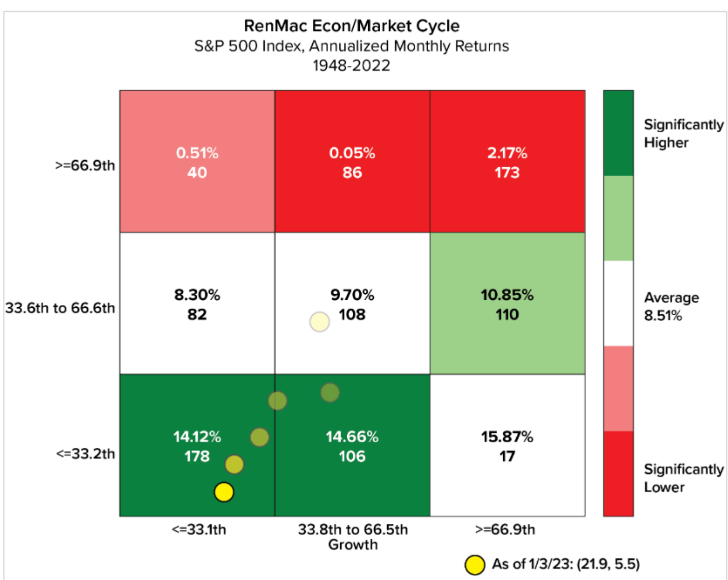
Negative Market Sentiment

Given the difficult investment climate in 2022, it is unsurprising that sentiment is currently among the lowest in decades. The chart below depicts the S&P 500 Index from January 2008 to today along with the American Association of Individual Investors (AAII) bull-bear spread. We observe that AAII sentiment is often a contrary indicator. In other words, when investors are most bullish, stock prices may be high. Conversely, when sentiment is most bearish, stock prices may be low and is a good time to buy. **Human behavior doesn't change, and we think current investor sentiment may indicate that current prices are attractive for long-term investors.**



Source: Bloomberg

Renaissance Macroeconomic Research also observes that current macroeconomic statistics are similar to past periods that preceded above average returns. In other words, for historic periods like what we're currently experiencing, where inflation has peaked, prospective returns have been strong.



Source: Renaissance Macroeconomic

Portfolio Positioning

Our portfolio remains attractively positioned relative to the S&P 500 with weighted average EPS growth of 21.1% for 2023 compared to only 9.4% for our benchmark and return on equity (ROE, a measure of capital efficiency) of 24.1% compared to 19.3% for our benchmark. Despite this more attractive growth and return profile, our portfolio trades at 15.4x forward P/E compared to 16.9x for the S&P 500. **Historically, our faster growing portfolio has generally traded <u>at a premium</u> to the market. However, our portfolio is currently trading at a <u>1.5x multiple discount</u> to the market.**

<u>Strengthening Fundamentals</u>

Further, we believe that company fundamentals within our portfolio are strengthening. For instance, **Danaher's (DHR)** Life Science and Diagnostics businesses enjoy over 80% recurring revenue and continue to see robust customer demand. Danaher is also in the processing of spinning off its more cyclical Environmental & Applied Solutions business and may use the proceeds to lower leverage or pursue value-enhancing M&A.

AerCap (AER), the leading aircraft leasing provider to airlines globally, is seeing the beginning of an airplane replacement cycle. Moreover, since the acquisition of GE's aircraft leasing business, AerCap has sold non-core assets and used cash flow to lower leverage. With leverage now under 2.7x, we expect AerCap to use future free cash flow towards share buybacks, which would enhance shareholder value as AerCap currently trades at just 8x P/E.

Sherwin Williams (SHW), a leading paints and coatings company, has successfully integrated prior acquisitions and used its position to raised pricing to combat inflation. Sherwin has a history of raising pricing during periods of high input cost but retaining that pricing as costs fade. We expect a similar dynamic benefiting profit margins in 2023 and beyond as raw material costs moderate.

<u>Investing for the Future</u>

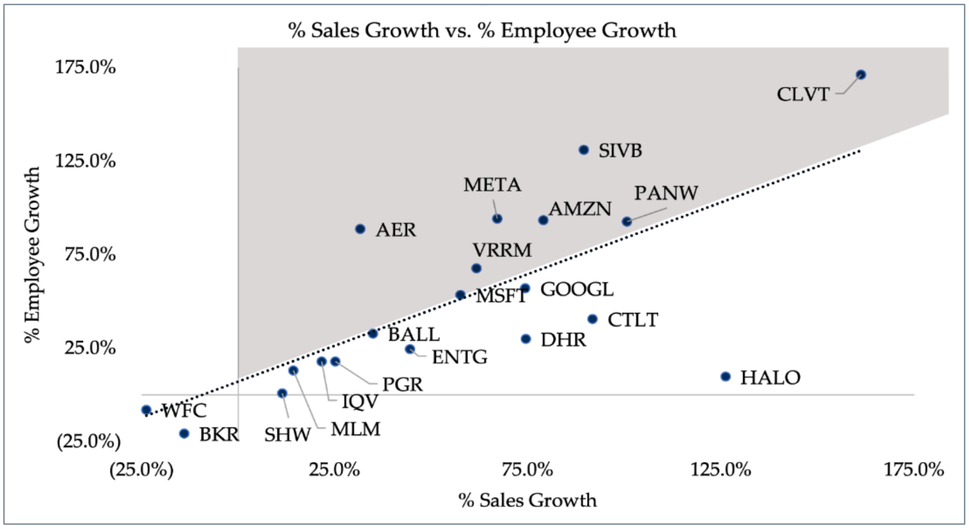
Market volatility is never pleasant; however, businesses do not simply grow in a straight line. During periods of market volatility and drawdown, leading companies often lean in and reinvest in their businesses. Most of our portfolio companies took some action in 2021 and 2022 to strengthen or expand their products and addressable markets. Here are some highlights:

Microsoft	Acquiring leading gaming company, Activision Blizzard
Alphabet	Acquired Mandiant (cyber defense, threat intelligence and response)
amazon	Acquired MGM studios, iRobot and One Medical
paloalto NETWORKS	Acquired multiple security companies
AERCAP	Acquired GECAS, GE's airplane leasing business
DANAHER	Acquired Aldevron (expands biologic and cell/gene therapy capabilities) and is spinning off its Environmental & Applied Solutions business

Halozyme	Acquired Antares Pharma which expands HALO's addressable market
Catalent	Acquired several drug product & substance manufacturing facilities
svb Silicon Valley Bank	Acquired Boston Private to extend into wealth management
Clarivate Analytics	Acquired ProQuest, enhancing its catalogue offerings
Entegris	Acquired CMC Materials
VERRA MOBILITY	Acquired T2 Solutions

<u>Renewed Focus on Profitability</u>

As we emerge from this period of easy money and heightened spending, we observe that several of our portfolio companies still have cost cutting opportunities. The chart on the next page plots company sales growth against employee headcount growth since 2019. While many of our companies grew headcount to meet elevated demand, which allowed them to maintain sales productivity (on an employee basis), several grew their employee base either organically or through M&A without a corresponding increase in sales. We are engaged with our companies on efficiency and productivity, and our research suggests that more can be done. With greater focus on these metrics, we believe many of our companies can protect or even expand margins despite the slower economic backdrop.



Source: TCM, Company Filings

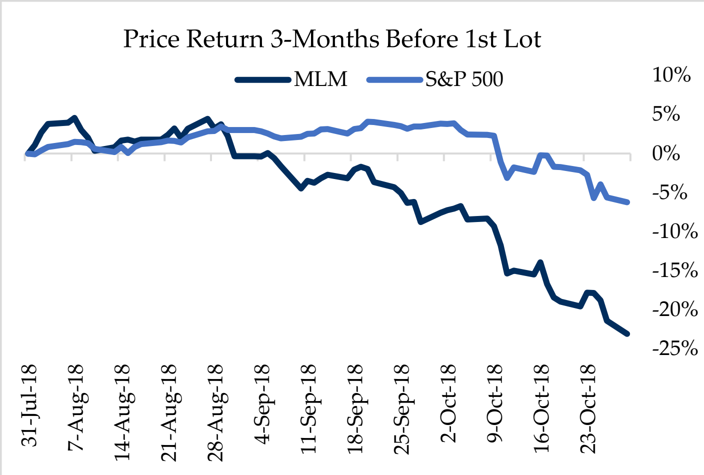
Sowing Seeds for Future

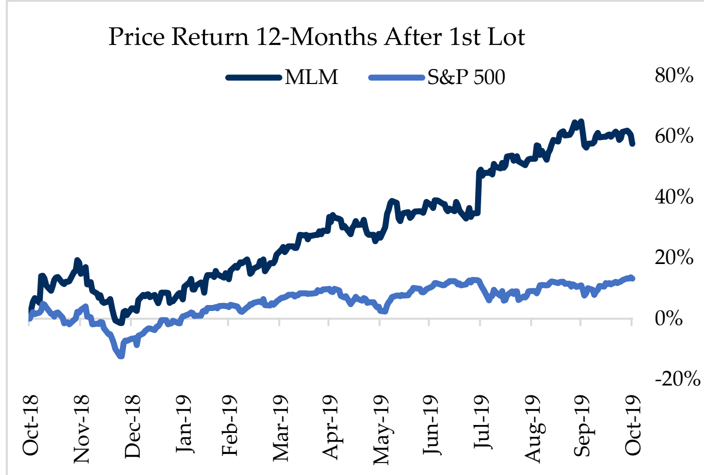
In every market drawdown, we employ a three-step research process. **First, we reassess our portfolio holdings. Second, we make adjustments. And third, we go hunting for new ideas. We believe that some of our best long-term investments are added during periods of disruption.** Reassess our holdings during a drawdown allows us to build conviction and add if we feel the selloff as unrelated or overly penalizing actual fundamentals. But it also leads us to sell positions entirely if we view that the risk-reward framework has changed or if the thesis has been altered. This happened in 2022 with the shifting economic backdrop and persistently high inflation creating concerns over consumer spending and household balance sheets.

Block (SQ) is a fintech company that enables mobile and online payments. While we like the long-term shift of payments going from cash to credit & debit, we grew increasingly concerned about Block's exposure to small merchants in a potential economic slowdown. Also, not all acquisitions are successful or well timed. In mid-2021, Block announced that it was acquiring Afterpay, a leading provider buy-now, pay-later payments. Block believed that the cross-selling and growth opportunities justified Afterpay's high multiple at the time, leading to a deal that valued Afterpay at 24x estimated 2022 revenues. Block benefited from using shares to purchase Afterpay; with the compression in multiples, Block ended up paying 11x sales, which we believe was still too high. This inefficient capital allocation decision coupled with risks from a pullback in consumer spending led us to sell Block entirely.

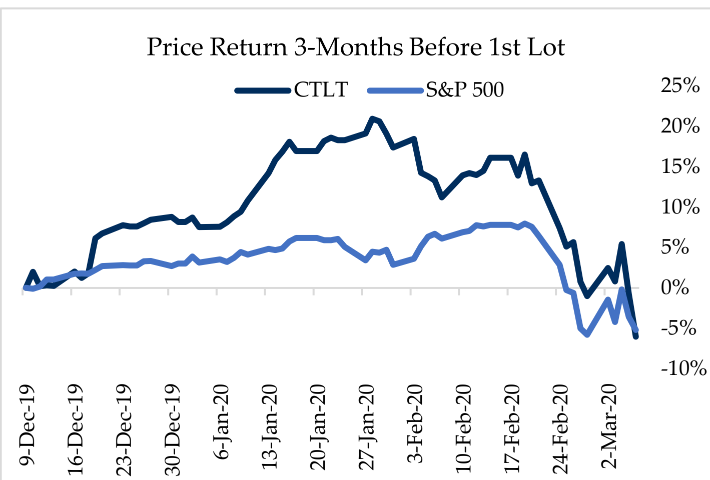
Disney (DIS) has an enviable franchise of irreplaceable and iconic content. However, the company may be in a difficult position with senior management changes, labor disputes, and significant discretionary consumer spending risk in the parks and cruise businesses. Both Block and Disney detracted from our returns in 2022. We redeployed the proceeds towards existing positions where we had more conviction and funded new investment ideas.

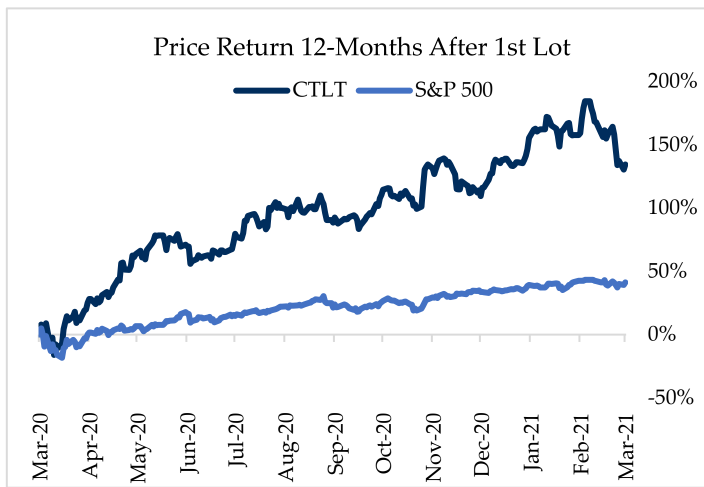
Using this three-step process, we have added some great long-term holdings in prior drawdowns. In 2018, we had been researching **Martin Marietta Materials (MLM)**, a leading aggregates company. We admired the near monopoly of its local quarries, strong end market demand, and seasoned management team. But these characteristics also meant Martin Marietta traded at a premium multiple. During the market drawdown in the fourth quarter of 2018, Martin Marietta sold off more than the market and we used that opportunity to establish our position. Martin Marietta has significantly outperformed since.



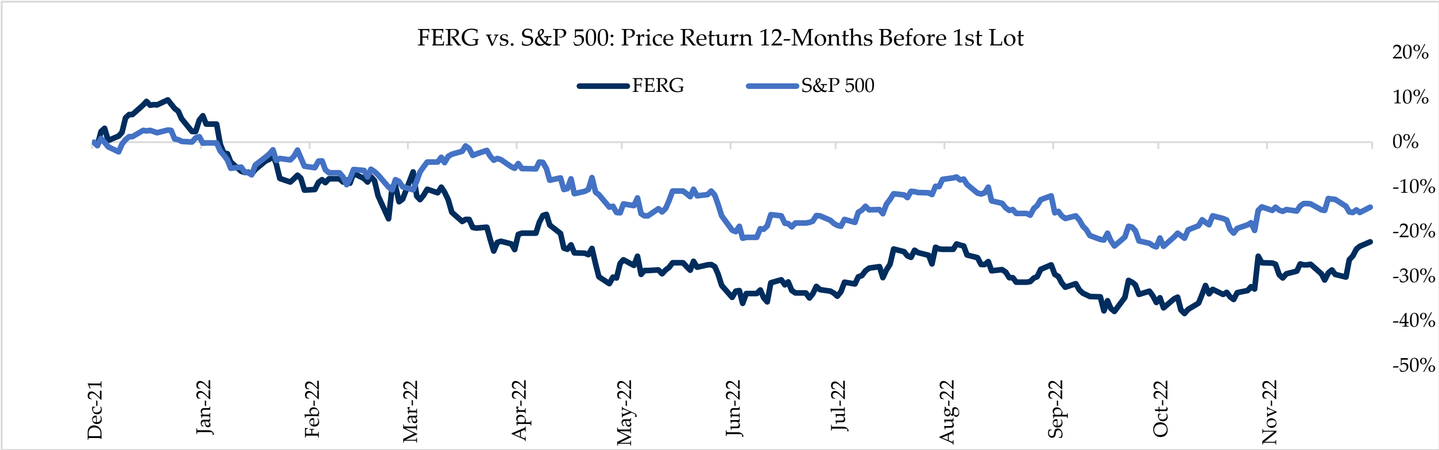


In March 2020, the world was experiencing the onset of COVID shutdowns. Ironically, we probably had more uncertainty then than we do now. We didn't know when and if an effective vaccine would be developed or how long stay-at-home mandates would be in place. The S&P 500 fell 34% over a span of 5 weeks. We had been researching and monitoring **Catalent (CTLT)**, a leading provider of drug delivery solutions for pharmaceuticals and biologics, for nearly 2 years up to that point. We admired Catalent for its long-term partnerships with leading pharma and biotech companies, high switching costs, and its exposure to the growing market for biologics. Not surprisingly, these characteristics were also recognized by the market and Catalent traded at a premium P/E. During the COVID-induced sell-off, Catalent declined to more reasonable levels and we initiated a position. Shortly after our purchase, Catalent received several contracts to manufacture COVID vaccines. The stock quickly recovered and became our top contributor in 2020.





We are looking to apply this same framework of hunting for great businesses in the market today. We selectively started positions in a handful of new companies during 2022. One recent addition is **Ferguson PLC (FERG)**, a leading distributor of plumbing, HVAC, and industrial supplies. Ferguson operates over 1,700 branches and connects millions of customers with thousands of suppliers. We believe Ferguson creates a competitive edge through its employees, who provide high service and expertise to contractors, and its stores, which offer wide product breadth and availability. In fact, over 75% of sales are from markets where Ferguson is the #1 or #2 provider. Given that the average home in the U.S is over 41 years old, we believe that demand for repair and maintenance will remain strong over the long term. The Fed's aggressive rate hikes caused housing-related stocks to contract much more than the market, including Ferguson which fell from trading at 22x P/E at the end of 2021 to 11x P/E when we started our position. While Ferguson is exposed to the housing cycle, our analysis indicates that it is more leveraged to repair and maintenance as new home construction makes up just 18% of sales. Thus, we believe current prices represent an attractive entry point.



Looking Forward

We have managed through major market drawdowns before and are employing the same strategy to navigate the choppy market today. We believe that inflation has peaked and that the fundamentals underlying our portfolio companies are strong and improving. Many of our portfolio companies are taking advantage of the market weakness through strategic investments and acquisitions. We believe the seeds are being planted for future returns. Only time in the market will enable us to harvest the rewards. Thank you for your partnership and trust in us. If you have any questions, please contact us.

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 December 31, 2022 are -33.25, 1.77, 5.57 and 8.19 respectively. The 1-year, 3-year, 5-year and 10-year returns of the S&P 500® Index as of December 31, 2022 are -18.11, 7.66, 9.43 and 12.57 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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Select assets shown; additional [strategy] investment information is available including the complete portfolio upon request.

Price returns for Martin Marietta Materials (MLM) and Catalent (CTLT) were sourced from Bloomberg.

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