TRAN CAPITAL MANAGEMENT

Multi-Cap Growth | First Quarter 2023

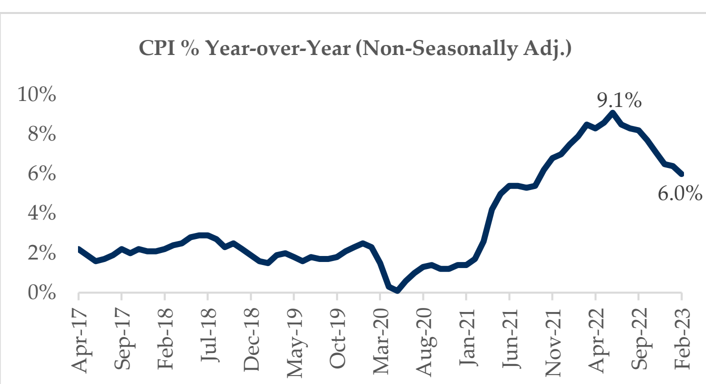
Dear Clients and Friends,

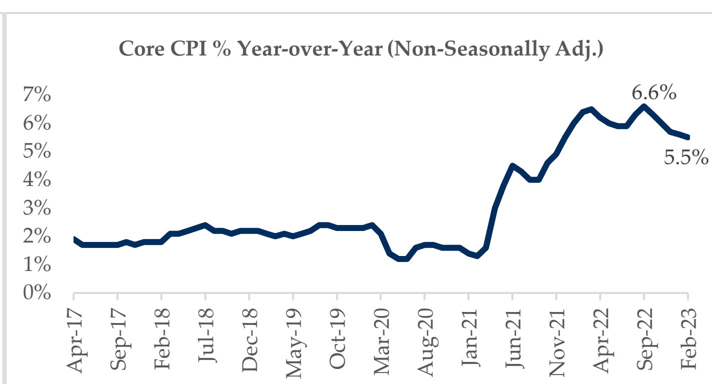
We hope you and your family are well. As you know, we seek to invest in high quality companies that grow and sell at reasonable values. Over the past year, stock picking has been superseded by macro factors. We think the environment is about to change such that stock picking will have a meaningful impact on stock prices rather than macro factors driving stock prices. For the first quarter of 2023, our Multi-Cap Growth Strategy returned 5.98%, net of fees, vs. the S&P 500 Index's return of 7.50%. Our three best stocks were, Catalent (CTLT) +46%, Palo Alto Networks (PANW) +43%, and Meta Platforms (META) +76%. Our three bottom performers were SVB Financial (SIVB) down ~50%, Halozyme Therapeutics (HALO) -20%, and AerCap (AER) -4%. There was wider dispersion in our individual stocks returns than normal with Meta's stock up +76% (or Catalent +46%) and SVB's stock down ~50%. Overall, we think the prospective returns over the next one to three years will reflect our portfolio's ability to grow revenue and earnings. On that note, we expect our portfolio's earnings to continue to grow faster than the market's growth rate.

It is hard to believe that it has been three years since the start of the global pandemic. Three years ago, we just learned about COVID-19, started to wear masks, and didn't know if a vaccine could be developed quickly. As the economy shut down, the U.S. government unleashed both monetary and fiscal policy to support businesses and households. Additionally, the biotech and pharmaceutical industry developed safe and effective vaccines in record time. These actions provided relief from the impact of the global shutdown. However, this fiscal and monetary stimulus coupled with supply chain disruptions created stubbornly high inflation. Inflation is pernicious as it erodes the purchasing power for everyone.

Over the past year, the Federal Reserve aggressively raised interest rates from 0.25% to 5.00% to slow economic activity and bring down inflation. We believe that a combination of factors, including higher interest rates, an improved supply chain, and a dramatic reduction in money supply, is bringing inflation down. Our research suggests that inflation peaked last summer and will continue to decline.

While volatility remains elevated, we believe that the Fed is close to finishing its rate tightening cycle, investors' cash levels are high, and we continue to find selective and attractive investment opportunities. Despite current high volatility, we believe our portfolio companies will continue to grow over the next few years as they service customers and emerge stronger. Moreover, most of our companies' current valuations are lower than at pre-pandemic levels.





Source: Bureau of Labor Statistics

When unprecedented fiscal and monetary actions are taken, unintended consequences can arise. During the first quarter, we learned that one of the unintended consequences was that higher interest rates have hurt bank liquidity. The Fed's aggressive rate increases over the past year were partly in response to it allowing interest rates to stay too low for too long. By correcting so aggressively, the Fed's actions have caused a lot of damage to equity and fixed income valuations. For the stock market, the forward multiple on earnings has contracted from 22x to 17x. For the bond market, the value of bonds decreased as interest rates increased because bond investors will demand market interest rates in a higher interest rate regime.

Somehow this financial equation was not appreciated by the management team at **SVB Financial (SIVB)**. SVB failed in the first quarter due to a liquidity crunch and subsequent run on its deposits. In the days and weeks since SVB's failure, we've learned that SVB purchased 10-year U.S. Treasuries and Mortgage Back Securities (MBS) when interest rates were at historic lows in an effort to chase yields. So as the Feds raised interest rates, the value of these securities declined. The losses in these securities were unrealized and would theoretically recover if SVB were able to hold the securities to maturity. However, SVB's customer base are mostly technology and venture-backed companies, which can behave in a similar fashion. Due to the poor equity market environment and low fundraising activity, SVB's technology-focused customers drew down their deposits without replenishing their deposits. In March, SVB sold a portion of their fixed income portfolio, realizing a $1.8 billion loss, and attempted to raise capital in a stock offering to shore up its liquidity. This was a surprise and a dramatic change from the tone and commentary that management shared in their earnings call on January 19, 2023. During that earnings call, CEO, Greg Becker said,

> *"We expect the shift towards interest-bearing deposits to stabilize and could see an inflection point in net interest income and NIM in the second half of the year. <u>We believe that shift combined with progressive paydowns in our investment securities portfolio, again, roughly $3 billion a quarter, will provide meaningful revenue tailwinds that build throughout the year. And we have enough visibility at this point to provide full year 2023 outlook despite the market uncertainty</u> and those details are in our Q4 2022 earnings deck filed earlier today.*
>
> *<u>We're prepared if those things don't improve, again, which is important, and even if the market challenges are prolonged or get worse. It's important to note we have a high-quality very liquid balance sheet, which I know there will be lots of questions about; strong capital levels</u>; a seasoned management team, which we experienced navigating challenging markets and adding a lot of new people with deep experience as well; and a consistent focus on our long-term business strategy. So when you put all that together, we feel clearly better about the outlook than we did last quarter, where there was more uncertainty."*

After we listened to SVB's investor call for their stock offering on March 9th, we thought that if we were clients of SVB, we would move some of our deposits to another bank. In that scenario, we didn't think SVB was raising enough capital. This cemented our decision to sell our SVB stock. The market was moving quickly. We were able to sell about 96% of our position, but the stock was down about 50% year-to-date. We are very disappointed with these developments and quite frankly did not expect for SVB to be halted and collapse within 24 hours of their investor call to raise capital. In the days since SVB's collapse, various news outlets reported that clients withdrew over $40 billion of deposits on that fateful day.

We had successfully owned SVB several times over the past decade and recently rebuilt our position. Our thesis was that as a leading bank for the technology and biotech industry, SVB would benefit from the formation of new and innovative growth companies. Additionally, SVB has historically benefited in a rising rate environment. In other words, the bank's net interest margin expanded as it earned more on loans than what it paid for their deposits. SVB actually had more deposits than they needed to make all the loans that they wanted. **The critical mistake was when SVB's management invested their excess deposits into long duration bonds when interest rates were at historic lows.** Additionally, this bank failure also points to a failure in bank supervision. How could the regulators let SVB hold such a large duration mismatch for so long?

As we analyzed the fallout from SVB and other regional banks, we believe that there will be increased regulatory scrutiny on all banks, likely higher regulatory fees, and more stringent liquidity tests. Further, with a slowing economy, we expect all banks to increase their loan loss reserves, which would dampen earnings in the near term. Rather than wait to see what these new regulations will be, we decided to exit our remaining bank, **Wells Fargo (WFC)**. We first purchased Wells Fargo in November 2020 at ~$22.50 on our thesis that they had an opportunity to strengthen compliance, resolve past abusive practices, cut costs, and use their excess capital to buy back a significant number of shares. Wells Fargo has executed on much of our thesis. While all banks pulled back due to SVB, we were able to sell our position in Wells Fargo at over $40.

Portfolio Positioning

During the quarter, we also sold **Halozyme (HALO)**, a leading royalty-based drug delivery company. We first purchased Halozyme in May 2020 at ~$24.50. Halozyme was our best stock in 2022, up over 40%. While we are still constructive on Halozyme's growth prospects, we believe we found several companies with more upside potential.

During the first quarter, we re-established positions in prior companies whose valuations have declined to more reasonable levels. **PayPal (PYPL)** is a leading fintech company whose products help millions of merchants and consumers facilitate e-commerce and electronic payments. After a period of accelerated growth during the pandemic, PayPal's earnings growth rate is now a more normalized 12-15%. Additionally, we believe PayPal is appropriately embarking on a changing of the guard and is actively searching for a new CEO. Last year's market sell off has influenced PayPal's product focus as well as capital allocation priorities. Instead of pushing for prior ambitions of a 'super app', the company is refocusing efforts on its core PayPal button checkout experience (including one-click checkouts, native in-app checkouts, faster speeds, better web page placement and more), which we applaud. The company is now pausing acquisitions and instead committed to returning 80% of their free cash flow to share buybacks. At 15x EPS with no debt, we think there are many levers to unlock value at PayPal. **Previously, we sold our PayPal position at $116 and now have re-established our new position at $77, or 34% lower.**

Intuit (INTU) helps consumers and small businesses manage their tax, finances, and marketing campaigns. Intuit's main products, which include QuickBooks, TurboTax, Credit Karma, and Mailchimp, are leaders in their field and provide valuable and essential functions pertaining to money for individuals and small businesses, making Intuit's products very difficult to replace. Intuit was founded in 1984 and has carefully built QuickBooks into a platform that provides add-on services, such as invoicing, payments, payroll, and marketing solutions (Mailchimp). Meanwhile, TurboTax is disrupting the assisted tax preparation market with its Live offering and Credit Karma is powering consumer prosperity with its innovative ability to anonymously match consumers with credit and loan offers without pulling credit information. We think Intuit's moat is strong and improving. **Selling at 27x next year's earnings (vs. over 45x in 2021 when we sold our position), Intuit's valuation is back to its 2018 levels with a stronger market position than before.**

Aptiv (APTV) is a leading global technology and mobility supplier primarily serving the automotive sector. Aptiv's technology enables the transition to more electrified and software-defined vehicles. We have owned Aptiv, and its predecessor company, since 2015. We sold Aptiv in 2022 on our concerns that potential energy rationing in Europe due to Russia's war against Ukraine. In such a scenario, we thought that Aptiv's customers would cut or reduce manufacturing schedules, reducing orders from Aptiv for an undetermined time in Europe, which makes up nearly 1/3 of its business. Fortunately, European countries were able to avert this risk due to supply building and a warmer than usual summer, and we are now comfortable re-establishing our position.

Finally, we added **T-Mobile (TMUS)** to our portfolio. T-Mobile is a leading wireless carrier providing service to over 113 million customers in the U.S. After merging with Sprint in 2020, T-Mobile accelerated capital investments to integrate and strengthen its network and service offerings. Our research suggests that T-Mobile offers the best 5G network, is the low-cost provider, and is creative in bundling its offering with other services like Apple TV+ and Netflix. This has led to a low customer churn rate and a highly predictable revenue, earnings, and free cash flow business model. We believe capital investment will reduce over the medium-term, leading to a ~3x increase in free cash flow from 2022. Furthermore, we believe T-Mobile will direct the majority of free cash flow to share buybacks with the potential to reduce shares outstanding by over a third over the next few years. At 20x earnings with earnings accelerating, a reduction in capex, and a tremendous amount of share buyback, we think T-Mobile is set up for many years of compounding.

Looking Forward

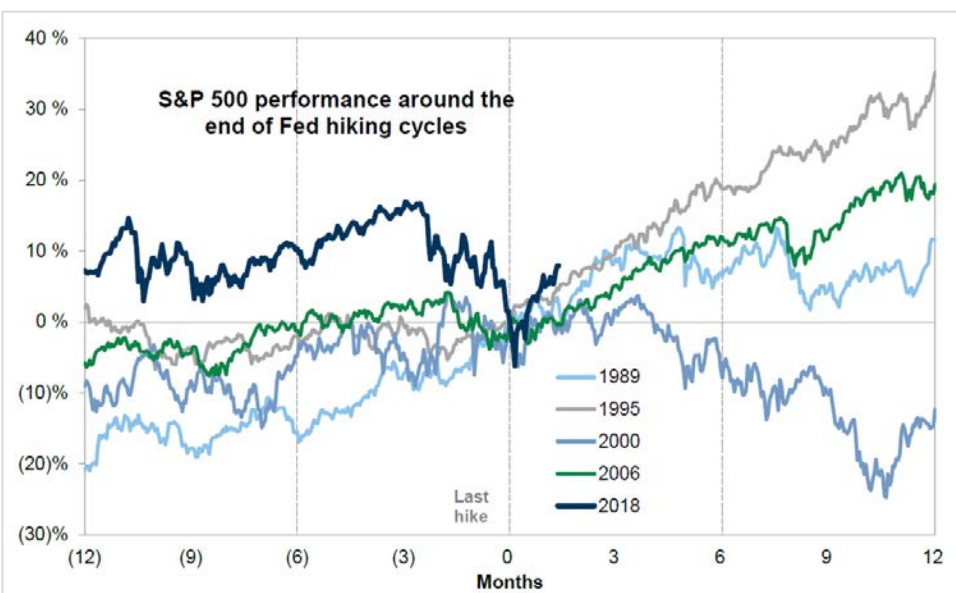
For over a year now, the market has experienced a dramatic period of volatility and multiple contraction due to the Fed's aggressive rate increases. We've managed portfolios during previous rate tightening cycles, but 2022 was the most difficult environment we've experienced. We want to share the following observations:

- **First, the stock market is forward looking and discounts future expectations.** As we approach a potential end to the current the Fed tightening cycle, we observe that the ends of previous Fed hiking cycles have often signaled the start of a new bull market.
- **Second, the preservation and, in many cases, an increase in corporate earnings** may come from cutting expenses, reducing workforce, and improving productivity**.** We are already seeing several of our companies announce significant layoffs and initiate cost cutting plans.
- **Finally, adopting and implementing technology can be a tool to improve efficiency and save costs.** For instance, using QuickBooks is faster and more efficient than relying on spreadsheets and other accounting methods. Our portfolio is well positioned with many companies whose products and services increase efficiency.

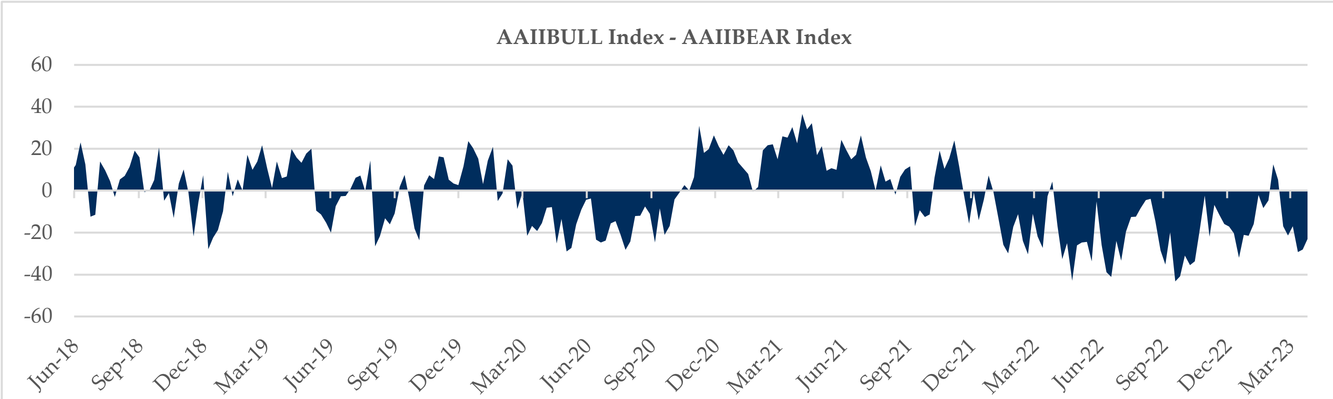
The chart from Goldman Sachs below depicts the stock market's 12-month return around the end of prior Fed hiking cycles. **As you can see, other than the dotcom burst, the S&P 500 returned double digits following the last Fed high over the next 12 months.**

Perhaps it is not surprising that investor sentiment continues to be bearish given all the global headlines, bank failures, and volatility. The American Association of Individual Investors (AAII) bull-bear chart on the next page is often a good contrarian indicator of prospective returns. **As of March 2023, investors are still very nervous.**

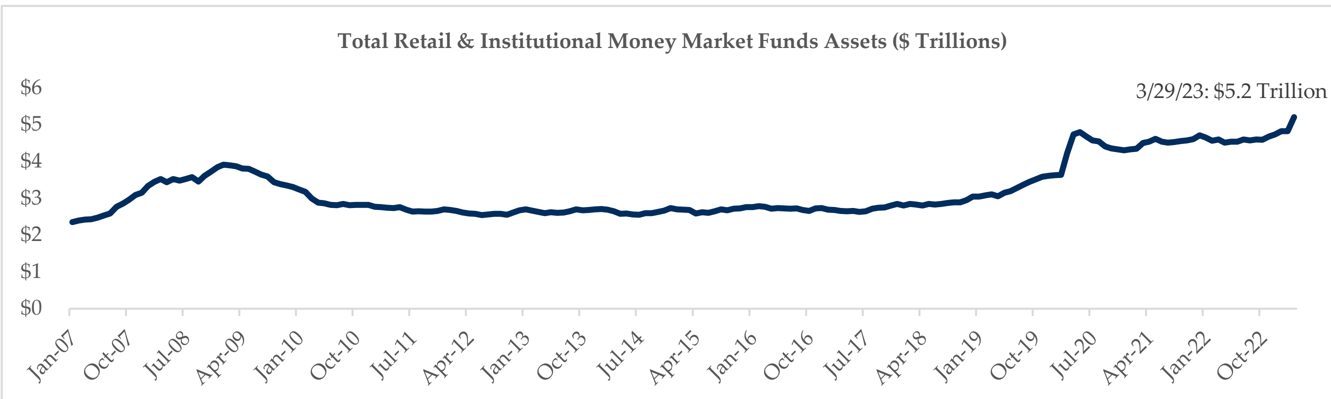
This bearish investor sentiment is also reflected in cash accounts. After the failure of three regional banks, individuals and companies quickly moved their cash to large banks and sold securities to raise cash. If the Feds' tightening cycle is in fact nearing its end, we believe many investors will again feel comfortable to put their capital to work.



Source: Goldman Sachs Investment Research, February 2023



Source: American Association of Individual Investors via Bloomberg



Source: Investment Company Institute via Bloomberg

We construct portfolios of leading companies that provide essential products and services. The past year has been difficult, but we are optimistic that the macro factors that have dominated the market will subside as inflation continues to cool and the Fed's tightening cycle comes to an end. We believe that this inflection point will enable stocks *in general* and our portfolio *in particular* to be driven by fundamental factors like recurring revenue growth, double-digit earnings growth, and high returns on capital. In fact, as of the first quarter 2023, our portfolio's estimated earnings growth is 29% vs. the S&P 500's growth of 0%. We believe that over the next one to three years, our companies will continue to navigate these markets and produce attractive earnings growth. Thank you for your time and interest. Please feel free to contact us if you have any questions.

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 March 31, 2023, are -20.61, 10.61, 6.54 and 7.98 respectively. The 1-year, 3-year, 5-year and 10-year returns of the S&P 500® Index as of March 31, 2023 are -7.73, 18.62, 11.19 and 12.25 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.

Benchmarks and financial indices are shown for illustrative purposes only and are provided for the purpose of making general market data available as a point of reference only. Such benchmarks and financial indices are unmanaged, assume reinvestment of income, do not reflect the impact of any trading commissions and costs, management and incentive fees, and have limitations when used for comparison or other purposes because they, among other reasons, may have a different trading strategy, volatility, credit or other material characteristics (such as limitations on the number and types of securities or instruments). No representation is made that any benchmark or index is an appropriate measure of comparison.

Select assets shown; additional Non-Taxable Multi-Cap Growth Equity 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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