TRAN CAPITAL MANAGEMENT

Partners Strategy | Second Quarter 2023

Dear Clients and Friends,

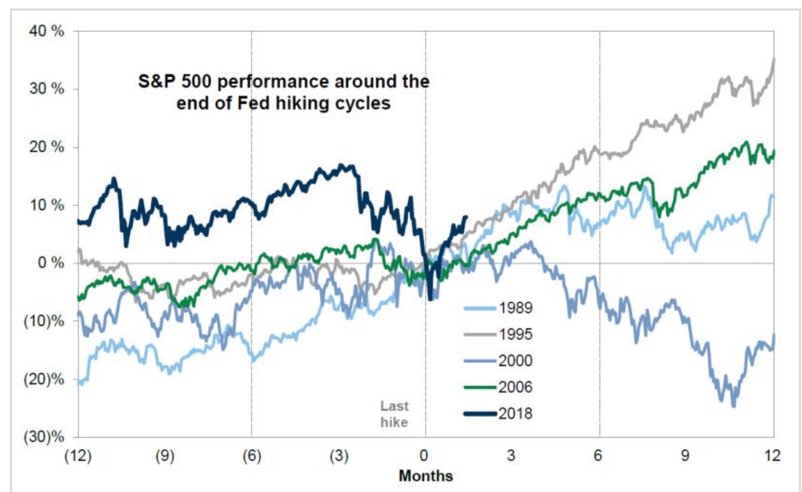
In our first quarter letter, we talked about how the markets are forward looking and with the use of technology many companies can preserve and grow earnings through these volatile times. These points may explain the strong second quarter performance. The stock market climbed a wall of worry that included the U.S. debt ceiling deadline, continued tight financial conditions, and geopolitical concerns. The S&P 500 appreciated 8.74% in the quarter, bringing the year-to-date returns to 16.89%. Our Partners Strategy grew 9.48% in 2Q, net of fees, bringing our year-to-date returns to 16.35% net of fees.

Interestingly, the S&P's strong performance this year has been led by the largest companies in the index. **The top ten companies contributed to essentially all the S&P 500's gain.** The equal-weighted S&P index has returned only 7.0% so far this year, less than half of the market-weighted S&P 500's return. At one point during the second quarter, Apple's market capitalization was bigger than the entire Russell 2000 index. We are watching for signs of the market broadening out, which we believe would be a healthy development. **As you know, our active share is about 85%, meaning we are 85% different than the market. While we have been able to generate double digit returns, we have many positions that have not yet participated in this market rally.**

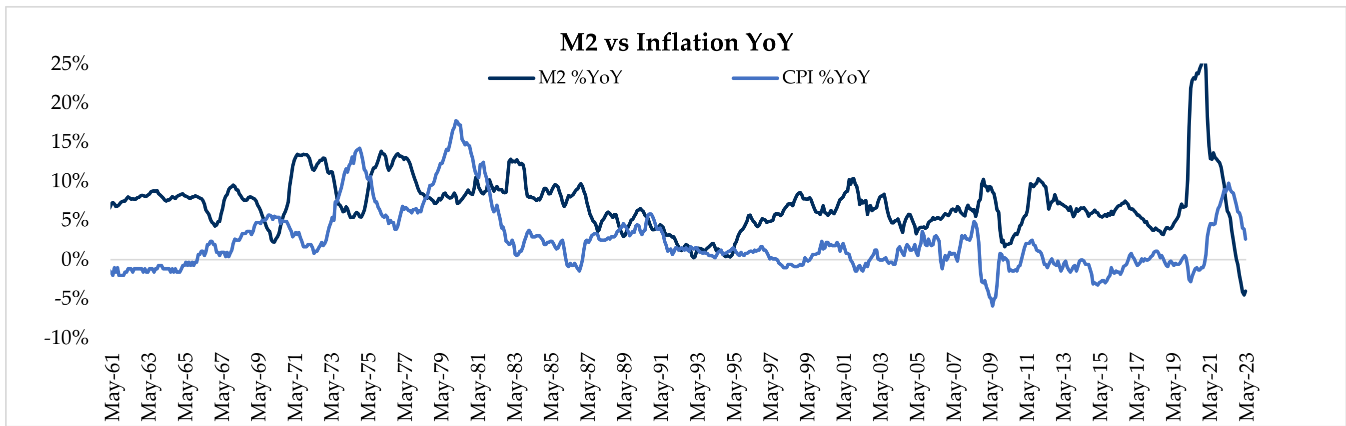
Perhaps the biggest factor impacting the market's return over the past year has been the Federal Reserve's rapid interest rate tightening to combat inflation. In prior letters, we have discussed how inflation peaked in June 2022 when CPI increased 9.1% y/y, and a combination of factors including a reduction in money supply (M2), improving supply chains, and a cooling housing market is reducing inflation. It also finally appears as if the Fed's tightening cycle may be close to the end. After ten rate hikes, the Fed decided to temporarily pause hikes at its June meeting. While Chairman Powell talked about potentially raising rates two more times this year, we believe the pace of rate tightening has slowed and conditions may warrant stopping soon. We believe fundamental factors such as revenue and earnings growth will return to being the main drivers of stock prices rather than rising interest rates, which have compressed stock valuations indiscriminately.

Interestingly, in prior periods when the Federal Reserve stopped raising rates, the market's subsequent one-year returns have been strong. The following is a chart from Goldman Sachs that plots how the market has performed in prior rate tightening cycles when the Feds stopped raising rates. In most instances, the market was up 10-30% one year later.

As we have shown in the past, money supply (M2) can be a leading indicator for inflation, and we view recent data on M2 to be encouraging. M2 growth has turned negative, starting in December 2022 and accelerating to -4% by May 2023.

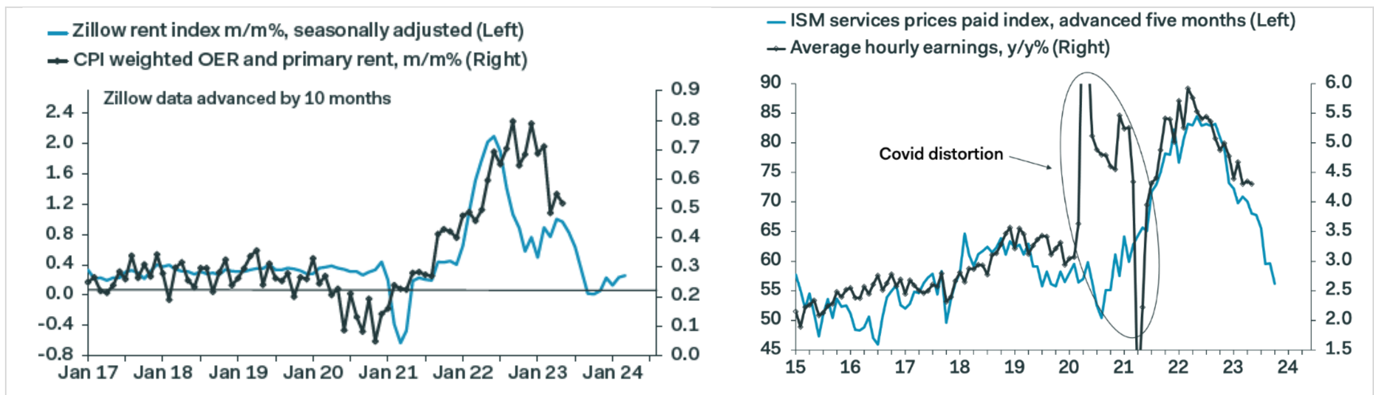


Source: Goldman Sachs Investment Research, February 2023



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

We've also discussed how shelter, made up of Owners' Equivalent Rent and Rent of Primary Residence, is the largest component of CPI at nearly 35% weight. While still increasing 0.5% m/m in each of the past 3 months, the rate of growth is clearly decelerating and should help cool inflation throughout the year if it continues to follow the path of the Zillow Rent Index (below, left). We believe the lag between the Zillow rent index and these CPI measures for housing costs can be explained by the CPI's calculation, which uses 6 panels to sample rental costs that are only updated on a rolling six-month basis. This means that each month's data only impacts the CPI housing figure by one-sixth, creating a lag effect relative to true housing inflation. Further supporting this is the declining rate of growth in average hourly earnings, which has slowed to 4.3% y/y, tracking the decline in ISM service prices paid on a 5-month lag (below, right).



Source: Pantheon Macroeconomics, June 2023

One of the most exciting themes so far in 2023 has been the acceleration of interest in artificial intelligence (AI), specifically in generative AI and the predictive capabilities of large language models. Whether it's Microsoft's partnership with OpenAI (the makers of ChatGPT), Google's release of Bard, or the technology infrastructure needed to process these queries, some market observers are describing this as the dawn of the next technology wave. Adoption has been rapid. For instance, it took Netflix three years to sign up one million subscribers. **It only took ChatGPT five days to reach one million subscribers. From its launch on November 30, 2022, ChatGPT gained 100 million users by January 2023, making it the fastest growing app in history.**

While it is too early to understand all the implications of using large language models or generative AI, we do have several positions in our portfolio that should benefit from this exciting trend. For instance, **Microsoft (MSFT)**, **Alphabet (GOOGL)**, and **Amazon (AMZN)** all offer enterprise scale processing power. Training the large language models used for ChatGPT and other generative AI apps requires a step function increase in computing power. For instance, ChatGPT's GPT-3 large language model was trained on 175 billion parameters while its GPT-4 model was trained on 100+ trillion parameters.

Additionally, with more data, the need for cyber security and analytics increases. Our investment in **Palo Alto Networks (PANW)** should benefit from increased demand for its solutions, which already apply AI for cyber security orchestration and management. Also, semiconductors enable the actual processing of data needed to train large language models. Our investment in **Entegris (ENTG)** should benefit from increases in semiconductor manufacturing, especially in the most advanced semiconductor chips. In these leading-edge nodes, higher content per wafer and more manufacturing steps means greater need for Entegris' purity and filtration solutions. While still early, we also believe companies with troves of differentiated data, such as **Intuit (INTU)**, will be able to leverage its proprietary data to create AI-assisted features that will further enhance its offerings and expand its moat. **We believe that over 25% of our portfolio directly benefits from increased demand from AI with an even greater percentage will indirectly benefit as they harness the power of generative AI to improve their products, reduce costs, and enter new markets.**

Portfolio Positioning

Among our top contributors in the second quarter were **Entegris (ENTG)** +35%, **Palo Alto Networks (PANW)** +28%, and **Amazon (AMZN)** +26%. **Entegris** is a leading supplier to the semiconductor industry, whose stock price was down over 50% in 2022. We added Entegris during the fourth quarter of 2022 based on our thesis that as the semiconductor industry works through excess inventory, a multi-year recovery should take place. Entegris is a leading supplier to all the semiconductor manufacturers and has used its leadership position to expand to other services with adjacent acquisitions. In fact, the most advanced semiconductor chips today have thousands of layers and thus require 4-5 times more micro contamination filters, advanced materials handling, and specialty chemicals to improve yields and chip performance compared to previous generations. During the first half of 2023, generative AI reached a tipping point and the leading semiconductor companies rallied. We did not know when this inflection point was going to hit, but we are happy to have a position that benefits from the acceleration in technology investments to support generative AI.

We first purchased **Palo Alto Networks** in 2019 on our thesis that, as a leading cyber security company, Palo Alto would benefit from the growing need for companies to protect their computing systems and data as more workloads moved to the cloud. Palo Alto has done a great job in transitioning its solutions from on-premise IT stacks to hybrid and cloud-based work environments. The company's revenue growth has been over 20% per year since our purchase and our research suggests that Palo Alto continues to enjoy a long runway of growth as spending on cyber security continues to be one of the highest priorities in enterprise IT budgets. The company should generate over $2.5 billion in free cash flow this year compared to only $926 million in 2019.

Amazon was down 50% in 2022 as technology stock valuations declined in a rising rate environment. Further, Amazon invested to build out its distribution warehouses and hired aggressively to support demand during COVID, which led to underutilization of its network as COVID faded. Over the past few quarters, the company has slowed capacity buildout and cut expenses to better match customer demand. This has helped Amazon return to positive earnings growth in 2023. Additionally, Amazon Web Services is poised to accelerate as generative AI tools grow in popularity on its platform. These tools require a step function increase in computing power, pricing, and margins. Year-to-date, Amazon is up 50%.

We believe the interest in technology stocks has left many high-quality growth companies selling at attractive valuations ignored. As we look at our current portfolio, among the bottom three from a year-to-date price performance perspective are **Danaher (DHR)**, **PayPal (PYPL)**, and **T-Mobile USA (TMUS)**. While each is down for its own reasons, all three companies are performing well fundamentally. Moreover, we believe that each is taking active steps to increase shareholder value.

Danaher's management team has a strong history of making smart acquisitions that have expanded its addressable market and augmented its growth. We forecast that by the end of this year, Danaher's leverage ratio will have declined from over 3.0x in 2019 to under 1.7x. Further, Danaher is in the process of spinning off its Product Identification and Water Quality businesses, which we believe could result in a dividend back to the company of $2-3 billion by the end of this year. Thus, Danaher's balance sheet and strong FCF generation of $7 billion this year could create opportunity for another value-enhancing acquisition. Some prior acquisitions include GE Healthcare's bioprocessing business and Aldevron, a leading manufacturer of plasmid DNA, proteins, and enzymes used for biologics.

A transaction could provide incremental upside over its continuing businesses that have 80% recurring revenues and grow alongside improvements in patient care and pharma/biotech R&D.

PayPal is a leading e-commerce payments company. In 2022, the company shifted its capital allocation priorities from new user acquisition to increasing existing customer base engagement. Thus far in 2023, PayPal has made strides in improving the core business, cutting costs, and buying back shares. We applaud this focus. PayPal recently completed the integration of several disparate processes and IT systems. This took several years to complete as the company was operating its payment processing network while simultaneously rebuilding its IT architecture. We are encouraged that a unified IT architecture will enable PayPal to improve and expand its services. Additionally, with PayPal's planned repurchase of ~7% of shares this year, we believe the stock will have price support and perhaps unlock shareholder value soon. At 13x P/E (NTM) and 8.5% FCF yield (FY24) with zero debt, we think PayPal is very attractively valued.

T-Mobile is a leading wireless network operator. We believe that the merger with Sprint has enabled T-Mobile to offer one of the best 5G networks at the lowest cost. This differentiation has enabled the company to gain market share vs. its major competitors. During the second quarter, there were reports that Amazon was in discussions with Dish Network to offer a low-cost mobile service to Amazon Prime customers. While we take any potential competition from Amazon seriously, we do not think this rumor is likely to materialize as Dish's network is not competitive from a coverage standpoint and would require significant capital investment and time to catch up. This would be an uphill battle given Dish's 10x net leverage and negative free cash flow. Further, Dish currently licenses capacity from T-Mobile and AT&T to supplement its coverage; however, these agreements do not allow Dish to resell that capacity to a third party. We believe T-Mobile is poised to grow FCF from just over $3 per share in 2022 to over $16 per share by 2025. With its network buildout largely complete, declining capex needs will increase FCF available for buybacks. In fact, we believe T-Mobile has the financial capacity to buy back 1/3 of its shares outstanding over the next three years. At below $140 per share, T-Mobile is selling at ~11% FY24 free cash flow yield, a level that we think is very attractive.

Looking Forward

While there will always be macro concerns in the market, we strive to invest in a concentrated portfolio of growing companies that provide essential products and services and trade at reasonable prices. **Experience has taught us that we cannot time the market or when certain investment themes will hit a tipping point. We believe that by investing in leading companies and closely monitoring their business performance, our portfolio should generate returns consistent with the growth of our companies' earnings over time.** We believe our portfolio will grow earnings at a faster rate than the overall market while carrying a slight premium to the market. We believe that these characteristics have served our clients well in the past. We are grateful to be up double digits net of fees in the first half of 2023 but believe that there are several companies that have yet to participate in this market recovery. We've shared some of these opportunities in this letter and would be delighted to discuss any of our investments with you. Thank you for your support and we look forward to our next discussion.

Sincerely,

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Co-PM &
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Eric A. Winterhalter
President

Important Disclosure

Performance is provided as supplemental information and is based on the Partners Strategy 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 and 5-year net of fees returns of the Partners Strategy Composite as of June 30, 2023, are 9.20, 9.12 and 10.15 respectively. The 1-year, 3-year and 5-year returns of the S&P 500® Index as of June 30, 2023 are 19.59, 14.62 and 12.31 respectively. 3-year and 5-year performance figures are annualized.

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Select assets shown; additional Non-Taxable Multi-Cap Growth Equity investment information is available including the complete portfolio upon request.

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