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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Seeking Improving Fundamentals in Small Caps and Midcaps

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SECTOR — GENERAL INVESTING

TWST: Overall, how are small- and mid-cap stocks doing right now?

Ms. Prial: Although small- and mid-cap stocks have certainly done very well, they have done it despite a lack of interest in active investing in the space. And as we see it, there has been such a concern with volatility that many investors are confusing volatility with risk. What we see actually is the opposite; we see an area where companies are able to control their own destiny because they are small and agile. If the company management can come out with a new product, start to gain market share or somehow restructure their business to improve it, they are small enough that they can move the needle on their growth rate, and the sector doesn't reflect all of that potential. Although there can be more volatility due to the lack of liquidity, we actually don't think that equates necessarily with investment risk and that investors perhaps are throwing the baby out with the bathwater, if you will, as they look at the space.

From a market-structure point of view, we have seen an impact both from quantitative trading methods and ETFs. There is some work being done right now looking at changing technical trading pricing, experimenting with $0.05 pricing increments, which could be very interesting. The experiment is about to start at the end of this year. It's going to be a two-year trial on a small number of securities, and the idea is to see if that makes a difference in reducing the amount of high-frequency trades that are not related to fundamentals. They are going to make it more expensive to do high-frequency trades, making

it a better opportunity for fundamental investing. So we don't know how it's going to play out, but it is very interesting.

TWST: And what investable trends are you seeing now in the space?

Ms. Prial: The investable trends we are seeing today include a global environment where the U.S. really is one of the best places to invest, and as small- and mid-cap investors, we are somewhat more U.S.-centric than perhaps our larger-cap counterparts. It's not to say that our companies only sell product in the U.S., but they are primarily domiciled in the U.S., so benefiting from the repair that has gone on in the U.S. economy since the world changed in 2008 to 2009. We see that we have some advantages in this country in terms of infrastructure, transportation and certainly oil prices being down significantly from where they were a couple of years ago.

We still have a tremendous innovation engine, and we're beginning to see an economy where wages are starting to go up, employment has improved, household formation is starting to improve, and so all of these factors are leading to improved consumer spending after a five-year, maybe longer, period of consumers deleveraging their balance sheet. We do not think they are going to necessarily re-lever, but they can now spend in line with their income growth, and that is very positive for the economy. We actually think that right now there are a lot of investment opportunities out there, again, driven by this combination of innovation and improvements in the U.S. economy.

TWST: What do you like to see in a stock? What are the metrics that you're looking for?

Ms. Prial: We want to see companies whose businesses are improving on a fundamental level. We want to see business improvements at a point in time when we believe that the future growth prospects are not yet fully priced into the stock. So the first thing we look for in a company is a measurable indication that business fundamentals are improving. We generally look at revenue and earnings per share as we measure the business fundamentals, and when we see companies that are showing an improvement in their revenue and earnings growth rates, we dig deeper to understand the reason why the fundamentals are improving, how sustainable that change is, how good the management team is, will they be good enough to capitalize on this change in their business fundamentals, does it have a path that will lead the company to a sustainable growth rate that will be attractive not only to us but to other growth investors, and then again, finally, the idea that these catalysts are not yet fully recognized by others.

TWST: Are you seeing certain sectors that are more appealing than others right now?

Ms. Prial: Yes, we are, and of course, we always have sectors that we like better than others. We are growth investors, so not surprisingly, our biggest sectors are traditional growth sectors. Today, one of the big sectors that has a tremendous amount of innovation and excitement is technology.

There are some really exciting things driven by the pervasiveness of mobility, mobile devices, internet, video, data, the cloud — all things that we live with every day but that are really changing the way not only the business is done but the way that we live our lives. I mean, you think about an idea like the internet of things. We have connected cars, houses, refrigerators and connected everything else. We can argue whether or not this is good or bad, and some days I am not so sure — although I think the good outweighs the bad — but that's a very large theme.

Another big exposure in our portfolio is health care. This is a combination of secular and cyclical growth stories driven by innovation but also by demographics and the aging Baby Boomers, who want to age in a way that's very different than our parents and, certainly, our grandparents aged. I look at my peers, and we are not willing to go quietly into that good night. We want to stay active, think we're still young, be healthy, travel, ski, bike or whatever it is, and so that's driving demand for health care that's different than just the palliative care you would have seen in the past. This is coupled with a tremendous innovation cycle.

The other big area is consumer. There are some headwinds in parts of consumer but excitement in other area, so we are very selective. We like companies that are helping to disintermediate businesses. This includes internet services companies that are using the internet and using the power of all this bandwidth to change the way business is done, whether it's backdoor plays into online commerce, online banking using the internet to help with auto sales or research into travel.

Highlights

Nancy Prial and Saralyn Sacks discuss Essex Investment Management Company, LLC. In the small-cap and midcap space, Ms. Prial and Ms. Sacks believe investors often confuse volatility with investment risk. Rather, Ms. Prial and Ms. Sacks see these companies as being able to control their own destiny due to their size and agility. When choosing investments, Ms. Prial and Ms. Sacks look for companies with improving fundamentals and growth prospects that are not fully priced into the stock. They also dig in to learn what a company's catalyst is for the improving fundamentals, how sustainable the change is and if it has a good management team. As growth investors, Ms. Prial and Ms. Sacks are currently finding opportunities in technology, health care and consumer.
Companies discussed: Willdan Group (NASDAQ:WLDN); Silver Spring Networks (NYSE:SSNI); AxoGen (NASDAQ:AXGN); NanoString Technologies (NASDAQ:NSTG); LogMeIn (NASDAQ:LOGM); and Citrix Systems (NASDAQ:CTXS).

Within the consumer space, we also like the area of housing because we see that household formation is up, Millennials are moving out of their parents' basements. In many cases, they may just be renting, but that still drives demand for housing. So we like both housing as well as some of the related materials. We also think that there are a lot of opportunities that consumers, both Millennials and Baby Boomers, look at a little bit differently than consumers did in the past. For example, there are areas in leisure, health care or healthy living that are attractive to us.

TWST: I'm assuming because you emphasize growth, things like utilities probably would not be terribly attractive?

Ms. Prial: Correct. It would be hard for us to get excited about the growth rate in utilities per se. However, one area related to utilities that we like is energy efficiency. We own a small consulting company called **Willdan** (NASDAQ:WLDN) that provides energy efficiency consulting to utilities. We also own a company in the smart metering or smart electronic control business called **Silver Spring Networks** (NYSE:SSNI). So there are ways that we apply some of the innovation that's happening within the utility business, but we don't really want to own the utilities. We certainly wouldn't shy away from owning a company that paid a nice dividend, but we won't own a stock just because of the dividend play.

revenue is today. It is $1.6 billion versus $50 million in revenues this year, growing more than 50%.

They have a comprehensive product portfolio that addresses all the surgical nerve-reconstruction needs. Their products are improving efficacy, reducing surgery time and eliminating the need for a second procedure. It reduces pain, the time that the patient is in the hospital, and it improves the outcome.

1-Year Daily Chart of AxoGen

Chart provided by www.BigCharts.com

> ***"We have a small exposure to energy in the portfolio because I think you need to have some energy exposure as a hedge against something unexpected happening in the world. Having said that, our best guess is that oil prices are in a reasonably large trading range for the foreseeable future."***

TWST: What about straight energy investments?

Ms. Prial: We have a small exposure to energy in the portfolio because I think you need to have some energy exposure as a hedge against something unexpected happening in the world. Having said that, our best guess is that oil prices are in a reasonably large trading range for the foreseeable future, as we have demand growth that appears to be slower than one would have expected, say, five or 10 years ago. This is driven by changes in consumer behavior, energy efficiency, electric cars and other similar factors. We have supply that, although it's been curtailed in the short run, can get turned on again relatively quickly, so we think that these forces will keep oil prices in a trading range over the next couple of years. We want to pick our spots carefully so that we find a handful of investments that will benefit from some cyclical upturns, either an exploration company that has new finds or a services company that can exploit some of the interesting areas in the Permian.

TWST: Can you give us some health care names that you find particularly attractive right now?

Ms. Sacks: One example of an innovative company we like in the health care space is **AXGN** (NASDAQ:AXGN), and it's really an undiscovered and underfollowed med-tech name. They are a leader in innovative surgical solutions for peripheral nerve injuries, and they are the only company today that's focused on peripheral nerve repair solutions. The addressable market is enormous compared to what the

Another space is diagnostic and life sciences. One thing driving the change here is that the U.S. government raised NIH funding last year by 7% after a number of years with no increases. We have a few companies who have a significant exposure to the academic market that will be driven by this increase in NIH spending.

NanoString Technologies, Inc. (NASDAQ:NSTG) provides life science tools for translational research and molecular diagnostic products. Their core business revolves around the instrument that takes biological issue from a tissue and information from a tissue sample. They have a breast cancer diagnostic test, which tells you the risk of reoccurrence, and also companion diagnostic tests that partners with pharma companies to tell if a drug is working or not. All these run on their system called nCounter. They recently launched a second system that's smaller, so it's better for smaller individual researchers.

TWST: Will you invest in a company that is still involved in clinical trials that does not yet have an approved product?

Ms. Sacks: We will if they have another product that's already approved and is generating revenues. We won't invest in a company that's completely development-stage.

TWST: One of the names in one of your portfolios is LogMeIn. Why do you like that name?

Ms. Prial: LogMeIn (NASDAQ:LOGM) is a play on the mobile worker, and it is a technology company. They have a product that

allows you to connect into your office or conference remotely. Your company can be spread out at four different locations, and you can all go online and have meetings. We've owned the stock for a couple of years, and it's been a great performer.

We are particularly excited now because they are in the process of acquiring **Citrix's** (NASDAQ:CTXS) GoToMeeting product, so they will be the leader in this growing area of remote access and remote meeting. As you think about the world and the fact that we all want to work differently, travel is both expensive and time-consuming. This is an area that's really going to continue to grow as a way that people can enhance business.

TWST: How often do you sell a stock, and why? What are some things that would make you sell something out of the portfolio?

Ms. Prial: The turnover in the portfolios range from 40% to 75%. It is a little higher as you go down the market-cap spectrum. We hope to be able to hold the stock for 18 to 24 months. That is our initial time frame when analyzing the upside of our companies. However, we really want to maintain our positions for as long as the growth stories are intact and as long as we believe that the future growth prospects are not yet fully discounted in the price of the stock. So we can own a stock for a year, three years, or in some cases, for a decade or more as long as the growth stories and growth trajectories are intact and we believe that we can still make significant money.

What causes us to sell a stock is really a change in the growth story. The growth story has worked, but we recognize that something is going to change for the worse in a way that is likely to significantly change the growth rate going forward. For example, a competing technology is coming out that may indicate the market is getting fully penetrated. It could be a story that's more of a growth cyclical, say, as a semiconductor company or an energy company, and they're going into a down cycle in that industry. The other reason why we would sell a stock, and this is really the most important reason, is that our thesis has not played out. We want to be very quick to recognize when we've made a mistake or when things have changed and minimize damage to the portfolio.

TWST: How do you mitigate risk in your portfolios?

Ms. Prial: The best way to mitigate risk in the portfolio is the way we diversify the portfolio. When we look at portfolio diversification, we look at it on a three-dimensional matrix. The first look is at our sector allocation. We want to be aware of what is in the benchmark but not necessarily driven by the weights in the benchmark, because at times — in particular, the extremes — benchmark weights can really get out of whack and reflect what's worked in the past but not necessarily what's worked in the future. In order to manage the risk on a sector level, our largest three sectors can be no more than 75% of the entire portfolio. The maximum for any one sector is 50%, and there is no minimum. So if we don't think a sector is attractive, we don't have to own it at all.

The other two ways that we diversify the portfolio is more subtle, but it really does help mitigate the risk. First is diversification by the catalyst that generates the improvement in business fundamentals. We have five basic catalysts: corporate restructuring, industry consolidation, improving industries, market share gains and new products. I give them in that order deliberately because it goes from the least growth to highest growth rate. As you would expect, the companies within these buckets not only have different growth rates but also have very different betas and act differently in different types of market environments. By having exposure across a variety of catalysts that are driving improving business fundamentals, and improving revenue and earnings growth, we're able to diversify the portfolio with companies that have varying characteristics.

Next, we diversify the portfolio by the phases of growth. If you think of all companies, their phases of growth can be somewhat cyclical. We have three basic buckets here. Companies that are very early in their process of business improvement, we think of these as our farm team because these companies are unproven, underowned, underfollowed, undiscovered. These tend to be the smallest-cap names in the portfolio. They have tremendous growth potential, but we don't really know when they are going to get recognized. So when you think about the risk here, it's really an opportunity risk of: How long do we have to wait for them to get recognized?

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The other end is what we call our sustainable growth story. These are companies that tend to have somewhat larger market caps. They tend to be more classic growth stories and classic growth industries. Their business models, although improving, are somewhat steadier than those in the really early accelerator buckets and have wider institutional ownership. We're still buying them at a point in time when their future growth prospects are not yet fully discounted in the price of the stock, but the overall multiple that we're paying for these growth companies tends to be higher. The risk is if they miss on the growth rate or if they disappoint other investors; they're already selling at a higher multiple, so we have some price risk.

And then, in the middle, we have what we call visible emerging growth, which are companies where the business is getting better, they're starting to get recognized, ownership is growing, coverage is growing, etc. So these three tools help provide some protection against the volatility in the market.

TWST: For investors looking to the small-cap space, what is the best advice you would give them?

Ms. Prial: Patience. When you look at the long-term studies of small- and micro-cap outperformance, what you see is that, over time, investing in the bottom two or three deciles across the broad

U.S. market has paid off dramatically. I mean, the amount of outperformance that you get from investing in these names that are underfollowed, underowned, underappreciated can really be quite dramatic. But it's not a straight line. They don't get recognized every day. There are periods when they're just really neglected and the stocks may go sideways for some period of time.

It takes an ability not to expect gratification every day, not to expect outperformance necessarily every quarter but to trust that, over time, by investing in a bucket of companies with improving business fundamentals who are selling at a discount to their future growth prospects rewards will come as they get discovered, the market caps expand, the liquidity discount can disappear and investors can benefit both from the inherent growth of the companies as well as from some multiple expansion that happens as they move from microcap or very small cap into small-cap or midcap territory. So again, patience is really what you need to have.

You also need to size positions appropriately so that you can ride out the inherent volatility. But it is a place where the process of discovery is something where ETFs really don't work as well. It's a behavioral inefficiency in the marketplace, and at least at this point, it has not been arbitraged away.

TWST: Thank you. (LMR)

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