

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Benefiting from Growth Trends in the Small-Cap Space



**NANCY PRIAL, CFA**, is Co-Chief Executive Officer and Senior Portfolio Manager at Essex Investment Management Company, LLC. She is the portfolio manager for the micro, small and smid growth strategies. Earlier, she worked at BurrIDGE Growth Partners as the Chief Investment Officer and Senior Vice President responsible for the smid and small-cap growth strategies. The Essex Small Cap Growth Strategy was launched and developed by Ms. Prial in 2001 while at BurrIDGE. Previously, she worked for four years as a senior vice president and senior portfolio manager at American Century Investors where her responsibilities included leading the team that managed the Heritage Fund. She began her career at Frontier Capital Management where she was both a fundamental analyst and portfolio manager in the small and midcap area. She received a degree in electrical engineering and mathematics from Bucknell University and an MBA from Harvard Business School. Ms. Prial is a trustee at Bucknell and is the Chair of the finance committee. She is also on the executive board of the Evanston Art Center.

### SECTOR — GENERAL INVESTING

**TWST:** Could you tell me a little bit about the firm?

**Ms. Prial:** Essex Investment Management is a firm that is focused on growth stock investing. We are known for the early identification of growth, wherever that growth exists, within our investable universe. The firm has about \$700 million in assets under management. And we look for strategies where we believe we can add value through the research process.

**TWST:** And why do you think investors, whether they're retail or institutional, are looking for growth stocks now?

**Ms. Prial:** We think that investing in companies who are benefiting from growth in their industries, as well as the growth that they are driving through their own internal product development, marketing and research activities, gives the opportunity for investors to benefit from that growth as those growth prospects get fully recognized in the price of the stock. We do believe that, over the long term, stock prices ultimately follow earnings growth, and therefore, we want to be positioned to benefit from them.

**TWST:** Do you have an investment philosophy that sort of overarches all the investment strategies?

**Ms. Prial:** Again, our overarching investment philosophy is to identify growth trends early and to position our portfolio so that they are thematically focused, as well as focused on bottom-up stock selection, in order to capitalize on those areas of growth that we've identified through our research.

**TWST:** I understand that one of your strategies is a small-cap growth strategy. Could you talk a little bit about that one and some of its objectives?

**Ms. Prial:** Absolutely. So we believe that there is an exploitable

anomaly that exists within the smaller-cap sector of the market. In particular, we believe that these stocks can be very attractive opportunities because they are undiscovered. They're underfollowed, they're underowned, and in many cases, we believe they can be underappreciated for their future growth prospects. We've designed our small growth strategy so that we can take advantage of that anomaly that exists in the smaller-cap names within the market cap, within the investable universe.

In particular, we believe our small-cap growth strategy is very interesting because we start at really the microcap level of investing in stocks, where this asset class is truly inefficient because of the lack of coverage, the lack of institutional ownership, and we can buy up to the midrange of the small-cap sector. What that means in numbers is that we initiate purchases between \$50 million market cap and \$2.5 billion market cap, which skews smaller than our benchmark, the Russell 2000 Growth, but gives us an opportunity to own these companies through the process of them being discovered and recognized by other growth investors.

**TWST:** Why do you think that investors are looking for small-cap stocks now? Some of the large-cap ones seem to get a lot of the headlines, but are there a lot of opportunities in the small-cap sector?

**Ms. Prial:** Actually, we think that the opportunity in small cap is extraordinary, just because of some of that phenomena. There's a lot of attention in the media on these handful of very large companies that are doing very well, growing very quickly and really changing industries. What excites us is that there are a number of players below the radar screen that are also able to capitalize on these same growth trajectories or perhaps be suppliers into some of these very visible high growth names that all investors know about, but because media attention is not as

focused on them, the stocks sell at a discount to what we believe their value is, based on those future earnings growth prospects.

**TWST: Do you also see some of the stocks in the sector getting involved in merger and acquisition activity so that they might get acquired and merge with similar companies?**

**Ms. Prial:** There is generally some level of M&A activity that occurs within our space, and just for that reason, larger companies want to acquire a specific product line that maybe fills the hole in their product lineup, or gets exposure to a geography or a customer base that they don't have exposure to. I will tell you that, in general, although we're always happy when one of our companies gets acquired, it's a bit of a double-edged sword, as we believe that those future growth prospects maybe have not been recognized fully — if we could own the company for the multiple years of their growth trajectory.

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**TWST: And within the small-cap growth portfolio, are there certain sectors that you're watching carefully now?**

**Ms. Prial:** So because of our focus on growth and because our process is really focused on finding big, open-ended growth opportunities early, before those growth opportunities are well-recognized by the Street or by other investors, that tends to focus our portfolio in certain sectors. Right now, we have a lot of excitement in the areas of, not surprisingly, technology, health care, internet services, financial technology, as well as certain areas within industrials where we see some big innovative changes going on industrywide.

**TWST: In a lot of these same sectors you find the large-cap stocks represented. What are some of the common characteristics do you think in these sectors when it comes to the small-cap stocks that are found there?**

**Ms. Prial:** I would say there are two different ways that these small-cap companies can participate in these high growth sectors. One, as I mentioned, is they can be partners or suppliers into some of the larger-cap companies. So they are a component that then a **Google** (NASDAQ:GOOG) or an **Amazon** (NASDAQ:AMZN) or a **Facebook** (NASDAQ:FB) might use within their business structure. And the other opportunity is that they are market share gainers within the space, and so you can have a small company with a very innovative product that comes out solving a problem that perhaps has not been solved before, or with a better solution, a better mousetrap, if you will, for a problem, where they have the opportunity to gain significant share because they are starting from such a minimum share.

**TWST: Did you want to highlight maybe an individual holding that might be interesting to the readers?**

**Ms. Prial:** So one name that we think is a very interesting name, that is a beneficiary — this is a company called **Control4** (NASDAQ:CTRL). **Control4** produces hardware and software for home automation systems. So it is a company that is benefiting from the trends for the internet of things, so the fact that many areas of our homes are being automated, whether it's music, video, lighting, temperature, security, communications within the home. In addition, the underlying **Control4** hardware and software is used within **Amazon's** Alexa system. And so they're growing both in their own right as well as in partnership with **Amazon**. And that's an example of how one of these smaller companies can compete and succeed, even in a world where there are some very big players.

**TWST: When we talk about internet of things in the home, it goes beyond just maybe applying this in the kitchen, which a lot of people sort of associate home internet of things use. Could you explain that a little bit, what you might find this kind of technology being used for?**

**Ms. Prial:** It does go beyond just appliances. I mean, it really comes into your entire home environment, in an idea that everything will be connected. So if you think of wanting to be able to monitor the temperature and control the temperature in your home, whether you're there or not. You think about security, how you want to control access to your home, whether it's for you or for other people when you're away, to see what's going on with your home. Communications within the home, lighting systems, so that you can control where the lights are going on and off. Perhaps you forgot to turn the water off and you're traveling, you can do that now through the cloud, using the internet of things. So it really comes to entire home management, home automation that this play is evolving into.

**TWST: And you think you're going to see this increasing in popularity in people's homes, this kind of technology? Maybe even new homes, when they're put on the market, this could be a selling point for a lot of them, that there is this kind of technology in the house?**

**Ms. Prial:** We think so. At this point, it is more of a high-end technology as opposed to an entry-level technology. But just like all technologies, we think, ultimately, yes, this will be pervasive. We don't think this is a 40%-a-year type of growth opportunity. It's going to be a

#### Highlights

*Nancy Prial discusses Essex Investment Management Company, LLC and its small-cap growth strategy. Ms. Prial invests in growth stocks and looks to add value through the research process. She aims to identify growth trends early and then uses bottom-up stock selection to capitalize on those trends. Ultimately, over the long term, Ms. Prial believes that stock prices follow earnings growth, so she wants to position the portfolio to benefit from that. Ms. Prial is particularly interested in small caps because they are generally underfollowed and underowned, which provides attractive investment opportunities.*

*Companies discussed: [Alphabet](#) (NASDAQ:GOOG); [Amazon.com](#) (NASDAQ:AMZN); [Facebook](#) (NASDAQ:FB); [Control4 Corp.](#) (NASDAQ:CTRL); [Proofpoint](#) (NASDAQ:PFPT); [Mimecast Ltd.](#) (NASDAQ:MIME); [Charles Schwab Corp.](#) (NYSE:SCHW); [Mitek Systems](#) (NASDAQ:MITK); [Lumentum Holdings](#) (NASDAQ:LITE); [Johnson Outdoors](#) (NASDAQ:JOUT); [Callaway Golf Co.](#) (NYSE:ELY) and [Clarus Corp.](#) (NASDAQ:CLAR).*

slower, steadier ramp. But over time, we would expect that all homes will have home automation built into them.

And again, particularly on new homes, where you're not retrofitting. Well, it's easier to put it in when you're building a new home. You might liken it to, when you think about the development of technology in automobiles. Think about the simplest things — power windows and power locks — which back in the 1960s and 1970s were only on the most expensive cars. Today, the Millennials don't know what a hand-cranked window is.

#### 1-Year Daily Chart of Control4 Corp.



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

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**TWST:** And that generation also, you think, might be more open to having this kind of advanced technology in their homes?

**Ms. Prial:** Oh, absolutely. Everything they do, their entire lives are on their mobile devices. And so yes, we think that as that generation matures and enters the home-buying stage that the idea of having a connected home will be natural to them.

**TWST:** And did you want to highlight another stock?

**Ms. Prial:** Sure. One of the areas that we have been bullish on for a long time is the area of security software. And so two names that we own in that area, which are on the larger-cap side for us but are still very interesting small-cap names, are **Proofpoint** (NASDAQ:PFPT) and **Mimecast** (NASDAQ:MIME). They are focused really on email penetration. So it's first defenses against spam email.

One of the interesting things is that although this has been a problem for a very long time, and one would think that it was a problem that would have diminished in intensity, in fact, as the hackers get more and more sophisticated, the problem of email penetration continues to grow. And these fake emails that attempt to lure company individuals into disclosing corporate secrets have gotten more and more sophisticated, where they really look like something that came from within your company. And so both **Proofpoint** and **Mimecast** provide software that's a very important tool to allow corporations to protect their client information.

**TWST:** So both companies could provide services and products that would be part of a larger cybersecurity priority in a company?

**Ms. Prial:** Exactly.

**TWST:** And anything about either of these companies that you think would be particularly interesting, in terms of where their

products and services are going? Any direction or recent advancements that they might have had?

**Ms. Prial:** Well, again, we think that they are both really in the right place at the right time, where they are providing email management services that's part of a corporation's defenses against hackers, against intrusions, to protect corporate information, to protect their customers' information, to protect their client information. We think that as the number of incidents continues to grow and as the cost of defending against these incidents continues to grow and as the ability for these thieves to piece together all of the various pieces of personal information, that there is an increasing focus on the liability of the company who owns that, who has that information within their systems, of what they need to do to proactively protect against intrusion. And that is what both **Mimecast** and **Proofpoint** play into.

**TWST:** And do you think that there is a potential growth not only in the larger companies that might have a very large IT budget but also some of the smaller-to-midsize companies that are also concerned about this kind of email hacking?

**Ms. Prial:** Absolutely. They are both spending the money on this. Obviously, the larger companies have a much more comprehensive solution. **Proofpoint** tends to sell more midlarge. **Mimecast** is a little bit more focused on midsize companies that they sell to.

**TWST:** And are their clients found both in the United States and overseas?

**Ms. Prial:** Yes, they are global, both companies.

#### 1-Year Daily Chart of Proofpoint



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST:** And did you want to mention one last company?

**Ms. Prial:** So one of the other areas that we are particularly excited about I mentioned — the area of financial technology. Again, when we think about Millennials and how they live their lives, the idea of doing things on their phone and mobility is very important. But one of the challenges within financial technology is for the financial firms to identify how do you know who you say you are. So whether it is calling on the phone or whether it is accessing on your mobile device or accessing on your computer, how does that company, whether it is a bank, whether it is a company like **Schwab** (NYSE:SCHW) or **Fidelity**, whether it is a credit card company, how do you know that that person who claims to be who they are is who they say they are?

So we've found a couple of ways to play that. One is a company called **Mitek Systems** (NASDAQ:MITK), which provides its character recognition and document recognition products that are used to help banks and retailers identify customers at that point of contact. And some of this is involved with taking pictures of yourself on your phone so that you can submit a picture as well as type in a code. One of the interesting newer plays that is starting to develop is the idea of 3D sensing.

And so with 3D sensing, we own a company called **Lumentum** (NASDAQ:LITE), which is a component supplier of these 3D sensing chips. And when you have 3D sensing on, say, for example, your phone, when you take a picture, it will allow that picture to be rendered in three dimensions, as opposed to the flat, current two dimensions, which means it's much harder to spoof who you are. With 2D, you could take a picture of a picture, and the computer that's evaluating it may not know that that was a picture of a picture as opposed to a picture of a live face. But with 3D sensing, you can't do that. It has to be the actual person. And so we think that will be an extra layer of security that will enable the further development of financial technology and mobile financial technology, and provide a higher level of protection, both for the company offering the services as well as for the customer.

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**TWST: And during our discussion so far, we mentioned Millennials a lot. Given that there is technology and financial technology represented in this portfolio, do you think that as Millennials get more involved with investing in the market that it might be attractive to them?**

**Ms. Prial:** We would certainly hope so.

**TWST: And what do you think they might be looking for if they are looking at a strategy? I mean, some of them had obviously begun investing very early on, if things have been great for them. Others, they are moving in with their parents and maybe paying off student loans and those kinds of things. But as those things get taken care of, they might be investing in the market too?**

**Ms. Prial:** Right. So it is very hard to generalize about an entire cohort of people. But I think that as Millennials embark upon their investing lifetimes, and particularly as Millennials start to mature and go through the normal stages of life, that they will be looking, in many ways, for the same things that investors have always looked for, which is an opportunity to outperform the markets, to benefit from the general upward trend of equity markets over time and to build portfolios that allow them to outgrow the rate of inflation so that they can prepare for major life events, whether that be buying a home, having children, ultimately retirement.

On top of that though is, it does seem that the Millennial generation is very mission-driven. And so the idea of investing in areas that align with their values and their lifestyles appears to be more important to them than perhaps it had been to some of the previous generations. And so we think that by investing in growth opportunities that are, again, solving some big problems in the world, whether, again, it be health care, whether it be communications, whether it be environmental problems, whether it be enhancing productivity, that that will appeal to a sense of mission as well as to a sense of wanting to accumulate assets and provide for their future life events.

**TWST: So in other words, if they are concerned, let's say, about the environment and climate change, to have some devices in the house that sort of reduce energy usage through internet of things technology might be something that they could feel very comfortable with?**

**Ms. Prial:** Exactly. It can provide the double benefit of both doing well and doing good.

**TWST: And on the other age group, the Baby Boomers, do you see them still wanting to take part in the market, even if they are either in retirement or nearing retirement, as opposed to just getting money from fixed income sort of vehicles?**

**Ms. Prial:** Well, certainly, in today's world, the ability to make a sufficient return from fixed income is very challenging. Now, whether or not interest rates stay as low as they are is open to a lot of discussion. Yes, some people have been forecasting that rates are going to go up now for a couple of years; they have not yet done that. But it is reasonable to assume that rates will go up at some point in the future.

However, we believe that as Baby Boomers age, with better health, longer life prospects and more active retirements than previous generations have had, that ability to have money that is still

invested in growth areas so that your money can continue to grow, combined with part of your money invested in areas that throw off income, whether it be high-dividend-paying stocks or whether it be fixed income or other stable value areas, will be the right mix. So we think that Baby Boomers will stay more highly invested in equities than perhaps had been thought 15 or 20 years ago.

**TWST: And even if they're 65, they still might have 20 years left to let some of their portfolio mature.**

**Ms. Prial:** Exactly. And today's 65-year-olds want to continue to be active participants in life. They want active retirements. They may still be working. The retirement age, in terms of how people are actually living their lives, is going up. People are working part time, or they are in fields where you can continue to work for a much longer time. Keeping active like that keeps you younger and keeps your mind more agile. One of the little mini-themes that we have in the portfolio is this idea of outdoor experiential living, and it really is a combination of a Baby Boomer and Millennial play because both groups are very interested today in spending money on experiences, more than perhaps in accumulating things or accumulating apparel or accumulating furniture.

And so we have a couple of names; one of which is called **Johnson Outdoors** (NASDAQ:JOUT), which sells boating and fishing supplies and outboard motors, appealing again both to Baby Boomers who have been lifetime fishermen and fishermen as well as Millennials who are starting to enter into the world of fishing. We also have some equity in **Callaway Golf** (NYSE:ELY) and a small company called **Clarus** (NASDAQ:CLAR). One of their product lines is a company called **Black Diamond Equipment**, which provides equipment and gear for rock climbing and mountain climbing — again, appealing interestingly not only to Millennials but also to very active Baby Boomers.

**TWST: When it comes to Millennials, they might be looking for something that would be part of their life experience to invest in, and they might have a higher comfort level with investing in something like that?**

**Ms. Prial:** Potentially, yes. And there are areas that are growing. So again, the idea being that we can identify these growth trends early when those future growth prospects are not yet fully discounted in the price of a stock, and so our clients and shareholders benefit from the discovery as these companies and thematic areas get discovered and owned more broadly by other growth investors.

**TWST: Thank you. (ES)**

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