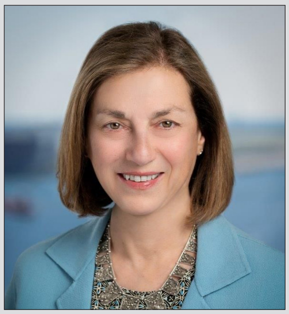
REPRINTED FROM JUNE 13, 2022

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Identifying Small and Micro-Caps at the Point of Accelerating Growth



NANCY PRIAL, CFA, is Co-Chief Executive Officer & Senior Portfolio Manager at Essex Investment Management Company, LLC. She also is the portfolio manager for the micro, small, and SMID growth strategies. Prior to joining Essex in 2005, Nancy spent six years 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 Nancy in 2001 while at Burridge. Previously, Nancy spent 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. Nancy began her career at Frontier Capital Management in 1984 where she served as both a fundamental analyst and portfolio manager in the small and mid cap area. Nancy earned a B.S. in Electrical Engineering and a B.A. in Mathematics from Bucknell University and an M.B.A. from Harvard Business School. Nancy serves as a Trustee Emeritus for Bucknell University. Nancy is the President of Women Investment Professionals.

SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Ms. Prial: Sure. As of the end of the third quarter, we were at $785 million in assets under management. We invest in growth stocks. We look for the early identification of growth, wherever that growth might exist. We want to buy those growth stocks at a point in time when their future growth prospects are not yet fully discounted in the price of the stock. We are a fundamental bottom-up shop focused on key secular growth areas that we think have the potential to outgrow the economy and the market over the next three to five years. We fully integrate ESG criteria into everything we do, with one product specifically focused on sustainability solutions.

TWST: And what is your investment philosophy when looking at growth stocks, especially now with what's going on in the market and the economy as we talk in May?

Ms. Prial: The bulk of what I do is focused on small-cap stocks. My particular focus is on micro-cap and small-cap; but for the firm overall, there's a lot of focus on small- and mid-cap stocks. We're looking for stocks that have yet to be discovered, where there's value added to be had — by identifying growth companies early when that growth has not yet been fully recognized by the market. We believe that in that small-cap space, these companies tend to be under-followed, under-owned, and we think therefore underappreciated.

We're looking for companies that are at an inflection point of improving fundamental business growth. We use the idea of revenue and earnings acceleration as a measurement to indicate companies whose businesses are fundamentally improving. Then we want to invest in those companies that have an opportunity for better-than-expected meaningful secular growth or cyclical growth, again, at a point in time when those future growth prospects are not yet discounted in the price of the stock.

TWST: Why does that approach make sense with the volatility that we're seeing?

Ms. Prial: Well, certainly within a volatile environment, there are great opportunities for stocks to get mispriced, both on the undervaluation side as stocks sell off, either due to market factors, or perhaps because an aspect of what they reported in the most recent quarter was misunderstood. Perhaps, the growth story is hidden within a company where part of their business is declining, but there's an interesting emerging part of their business that's starting to gain market share and starting to gain share as a percentage of their revenue. So those dislocations in the market caused by either market volatility, again, or individual company volatility, given opportunity, if you dig through the numbers and do the proper analysis to identify these companies at a significant discount.

On the other side, we can also take advantage of the volatility as sectors get very popular or as individual stocks get very popular and take some partial profits or perhaps complete profits and take advantage of the upside volatility in the market.

So a volatile market environment is always an interesting time to be an active stock picker. This particular market environment where small-cap stocks and micro-cap stocks have been particularly punished where the benchmarks overall are selling at multiples that in the past have indicated a recessionary environment, we think provides particular opportunities for people who want to start laying in positions who have a little bit of patience to let these companies get rediscovered and start to work again.

TWST: When we talk about individual companies that might be mispriced, what should investors look at about the company?

Ms. Prial: We're starting with the understanding that we want to invest in companies where their business is fundamentally improving. What that means to us, again, is we want to look for companies where the rate of growth of revenue, as well as the rate of growth of their earnings is better than it's been in the past.

We think that investing in companies near that inflection point of when their business is starting to fundamentally improve is a particularly attractive time to get involved with a company that has a good growth story, has a good management team, has a solid balance sheet, has good governance. The reason for that is that although the market can be quite efficient in valuing a company with a stable growth rate, the market is not very efficient at analyzing and valuing changing circumstances.

So, a company whose growth rate is improving tends to be valued where the growth rate used to be. There'll be a lag for expectations to catch up with the new growth — with the new reality of the growth rate. That lag is what gives that opportunity by the early discovery to benefit from not only the earnings and revenue growth that the company is showing — and so appreciation in line with the growth rate — but some extra appreciation as it gets discovered and as it gets revalued up as a higher growth company.

TWST: What specifically might someone want to look at on a balance sheet?

Ms. Prial: So we want to look at a couple of factors. We want to look at revenue growth, and we want to look at earnings growth. We want to make sure that the earnings growth rate makes sense relative to the revenue growth rate. What I mean by that is, we don't want to invest in companies which are manufacturing earnings growth, either by maybe cutting R&D or deferring expenses; you can get a sign from that both from the income statement as well as from the balance sheet. If you see things like payables are going up dramatically, that might be a sign that they're deferring expenses to make their earnings look better.

The other thing we want to avoid are companies that are generating growth because they are pushing product out the door, where maybe that demand isn't as strong as they're making it appear. The way you might uncover that is by looking at how much they're spending on their sales and marketing expense. If that sales and marketing expense is growing faster than their revenue growth, that might mean that they're pushing product onto customers.

Another good sign for this is to look at the balance sheet, look at accounts receivable. If the accounts receivable line is growing faster than their sales growth that can very often be a red flag that says that growth isn't as good as it appears. You also want to look at cash flow and make sure that the cash flow statement aligns with the income statement, so that everything is falling into place, and it all adds up.

TWST: Why don't we turn to maybe some sectors that might be interesting.

Ms. Prial: There are a couple of thematic areas that we're really focused on right now. What you have in common is a combination of big market opportunities, a lot of room for growth, as well as some level of government support, which leaves a tailwind to the companies that are taking advantage of these growth areas. I'll list the four big thematic areas first, and then we can drill down into individual ones.

What we're really focused on today are areas related to infrastructure spending. We all know that a big infrastructure bill was passed last year; but in addition to the federal spending on infrastructure, we're also seeing cities and states doing a lot of spending on infrastructure, doing things like repairing our transportation system, building out broadband and providing clean water.

A second area that we're very excited about is the reshoring of manufacturing in the United States. This is not new. This has been going on for several years, but we're seeing an acceleration of these trends with the supply chain challenges that we've been through for the last couple of years. Some of this is driven by factory automation and robotics, which can drive productivity and improvements. Some of this is focused on semiconductor manufacturing, pharmaceutical manufacturing, but really bringing these manufacturing jobs and bringing this manufacturing back to the United States — and other countries in the northern hemisphere — and driving some good economic growth.

The other two are growthier and maybe a little sexier, which is the idea that clean technologies are really gaining market share. The economy is turning green. This is whether or not we get a Build Back Better bill — although that would certainly provide a tailwind. Consumers want electric vehicles; we've seen the growth that Tesla's (NASDAQ:TSLA) had, but it's not just Tesla. There's growth with Ford (NYSE:F), there's growth with GM (NYSE:GM), there's growth with Volvo (OTCMKTS:VLVLY), there's growth with BMW (OTCMKTS:BMWYY), there's growth with Mercedes Benz (OTCMKTS:DMLRY).

What we're focused on are the suppliers of components into those electric vehicles, as well as some suppliers of the grid that will be necessary to power all these electric vehicles. This is a multi-year trend. We also are seeing interesting opportunities in smart buildings and smart cities

Highlights

Nancy Prial discusses investing in growth stocks early on, at a point in time when their future growth prospects are not yet fully discounted in the price of the stock. She explains that her firm takes a fundamental, bottom-up approach that focuses on key secular growth areas that they think have the potential to outgrow the economy and the market over the next three to five years. Ms. Prial says she focuses primarily on the small- and micro-cap space because these companies tend to be under-followed, under-owned and therefore underappreciated, and adds that micro-cap stocks in particular are incredibly inefficient. She also points out that within a volatile market there are great opportunities for stocks to get mispriced. Ms. Prial believes there are currently big market opportunities in four thematic areas: infrastructure spending, the reshoring of manufacturing in the U.S., clean technology, and personalized medicine.

Companies discussed: Tesla (NASDAQ:TSLA); Ford Motor Company (NYSE:F); General Motors Company (NYSE:GM); Volvo ADR (OTCMKTS:VLVLY); Bayerische Motoren Werke ADR (OTCMKTS:BMWYY) and Mercedes Benz Group ADR (OTCMKTS:DMLRY).

using technology to reduce the emissions from buildings, improve the quality of the air in buildings. Think about what we've been through with the pandemic — clean air, good filtration, good airflow is very important. There's a lot of money being spent, and work being done with that, as well as automating the grid and city. So you can have autonomous vehicles, you can have clean transportation, you can have better places to live.

Then the fourth area is the idea of personalized medicine. So whether it's genetic and diagnostic testing, whether it's tools to help with drug development and manufacturing, whether it's using artificial intelligence, both for diagnostic as well as treatment, all these areas that will allow doctors to really tailor health care solutions to individual's specific DNA, specific disease profile, specific chemistry. We think it is a very powerful growth opportunity really for the foreseeable future.

TWST: You work on micro-cap stocks. What do some people not realize about those? And why might they be of particular interest to investors now?

Ms. Prial: Well, they are incredibly, incredibly inefficient. We define micro-cap as companies below $750 million market cap at time of purchase. So these are companies that are really off the beaten track.

I think one misperception that people have about micro-cap companies is that by definition, they are all very early stage — what we think of as maybe development stage — companies, maybe in biotech, maybe in solar, maybe in wind, maybe companies that are making different kinds of electric trucks or electric cars. The reality of the micro-cap space is actually the vast majority of micro-cap companies are companies where the revenue line is meaningful; it's just the market caps that are very small.

The market caps are small, because the companies either have never been recognized, never been identified by Wall Street or not widely owned by institutional investors. Therefore, there's an opportunity, again, for this process of discovery as these companies grow and get bigger for other institutional investors to jump in and to reevaluate the stocks, to revalue them upward, in line with their growth rate. Or there are companies that were more highly valued, then maybe they missed a product cycle or maybe the management team was good at taking them from $25 million to $50 million in revenue, but wasn't able to take them to $100 million in revenue and they needed to bring in some more seasoned management team. Or maybe they had a great product idea, but it wasn't quite ready for the marketplace yet, and they had to wait. In the meantime, the stock fell out of favor.

Those are some of our favorite stocks in the micro-cap space. We think of them as reemerging growth stories; less kindly, one might call them fallen angels. But they're companies where they have fundamentally solid business prospects and they've just needed something to be fixed.

If you can identify them again at a point where their business fundamentals are improving; maybe they've brought in the right management team, they've got a better product out there, the market is ready for the product today, where it wasn't a couple of years ago. That's a great opportunity to get in on the ground floor with a company that has revenues, which has a solid balance sheet — if they don't have earnings, they're on the path to getting to earnings, but the valuation doesn't reflect that. Today, with what we've seen in the micro-cap part of the business, the valuations are particularly attractive.

TWST: With some of the micro-cap and the small-cap, you have potential for merger and acquisition activity where either like-size companies might merge, or a bigger company might acquire a smaller company and then provide some synergies. Did you want to talk about that?

Ms. Prial: Yes, that is definitely a factor. That's not a primary driver of the way we invest, but we certainly see that happening a lot, both with the companies we own which are acquiring other companies, or perhaps like you say, a merger of equals.

One way to think about it is that our micro-cap stocks, in many ways, are like public private equity. Many times, the buyers of these companies actually are private equity companies, either growth private equity or more restructuring private equity companies which recognize the value inherent in these businesses that's not being recognized by the marketplace. They might take them private, do a couple more acquisitions, and then bring them public again; but we think that playing it on the public side, you get many of those idiosyncratic benefits of private equity while still having the liquidity of public stocks.

"We want to look at revenue growth, and we want to look at earnings growth. We want to make sure that the earnings growth rate makes sense relative to the revenue growth rate. What I mean by that is, we don't want to invest in companies which are manufacturing earnings growth, either by maybe cutting R&D or deferring expenses."

TWST: More generally, as investors experience the kind of market we're seeing today, when the Dow dropped over 1,100 points, what do they have to remember and how should they treat the whole process emotionally and rationally?

Ms. Prial: I think investors, both institutional and individual investors, need to remember that time horizon matters. One of the scarcest commodities in the market is patience. Patience pays off, compounding works, and compounding is incredibly powerful. So you don't need to double overnight, but you can compound at 10% or 15% a year on an individual stock basis. An overall portfolio, if it can compound at 7% or 8% a year, which is a long-term average of market compounding that we think small- and micro-cap stocks tend to do better than that over time, that can generate a lot of wealth.

So, as you look at these volatile environments, we think that you need to keep that in mind, ignore some of the day-to-day noise, and then pick your spots based on that combination of growth that's coming in better than expected, faster than it was growing in the most recent past, with a valuation that's attractive. If you stick to those basics and buy good companies that are getting better at attractive valuations, monitor to make sure those fundamentals stay intact, and then have the discipline to trim or sell when those valuations get to be extreme, that's how you compound and get those great returns over time.

TWST: So, the mistake that can be made in these kinds of markets is suddenly dumping a good chunk of your portfolio without really thinking about it ahead of time?

Ms. Prial: Absolutely. Remember where we were little over two years ago in March of 2020. The biggest mistake you could have made in March of 2020 was to sell into what was truly a scary situation. Markets go up over time; and so there's comfort in knowing that bear markets end. You don't know when a bear market will end, but you know that a bear market will end and that the market will come back.

The United States is a growth economy. We have incredible fundamentals in this country. We actually think that the economic underpinnings are stronger today than they've been for a long time with the reshoring and manufacturing, with the infrastructure spending, with the innovation that's occurring. So, on an individual stock basis, you want to make decisions when to buy and when to sell, but overall, for your portfolio, it's important to stay invested and to continue to invest in good times and bad.

not be as big a part of the economy going forward as it's been certainly for the last 30 or so years. The jury's still out on that — whether millennials and Gen Z consume at the same rate as their parents and grandparents. I think it's too soon to say, but there certainly is historical precedent that says this could be a generation that values experiences more than they do accumulating goods. So, we would be cautious in investing in sectors that are distressed.

Now, that doesn't mean there aren't areas of consumer spending that could be very interesting. Although there's some cyclical issues with some of the big, well-known e-commerce names, companies that are helping to power e-commerce, companies that are helping retailers understand how to attract customers and retain customers. There are some software companies that are focused on that, that is a big growth opportunity for the marketplace. In addition, companies focused on that travel experience, particularly discounted opportunities for travel, there's certainly a cyclical opportunity as the world reemerges from COVID, a pent-up demand for travel, and we think that will be a good place at least over the intermediate time, where there will be some growth opportunities.

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TWST: What about for those who are in retirement or nearing retirement, especially those concerned about their dividends — or just their stocks in general — to maintain their quality of life? Any special advice for them in this kind of situation?

Ms. Prial: Well, hopefully they have well-balanced portfolios that they have continued to monitor on an appropriate basis and to rebalance appropriately. You would feel bad if you came into this over your skis, with companies' stocks only, and with too much exposure in the most highly valued sectors of the market. I think it's important to have an asset allocation that you're comfortable with and a volatility that you're comfortable with. That is an individual decision for each investor.

But you want to take advantage of market dislocation. So if the stock market is selling off faster than the bond market, that's a great time to do a rebalancing and to put a little more back in equities to get back to your target allocation. Again, understanding that as the economy grows, these markets will come back and that stocks tend to go up over time; so it's just a matter of a disciplined process of looking at your asset allocation, hopefully starting out in a good position and then, again, taking advantage of both ups to trim and downs to add.

TWST: Some stocks may be in sectors that are undergoing long-term changes. Let's say in retail, where shoppers now buy a lot online. Do you have to consider the trajectory of the sector?

Ms. Prial: Absolutely. We think that that's really important. So, there are sectors and individual stocks that can be what we call "value traps." They look cheap, but they're cheap because they're distressed. Retail is a great example. The U.S. is still over-stored in terms of real estate devoted to retail. Consumption may be something that will

So you need to drill down into a big sector and identify those pockets that have favorable fundamentals. But avoid those pockets where you're in secular decline.

1-Year Daily Chart of Tesla Inc.

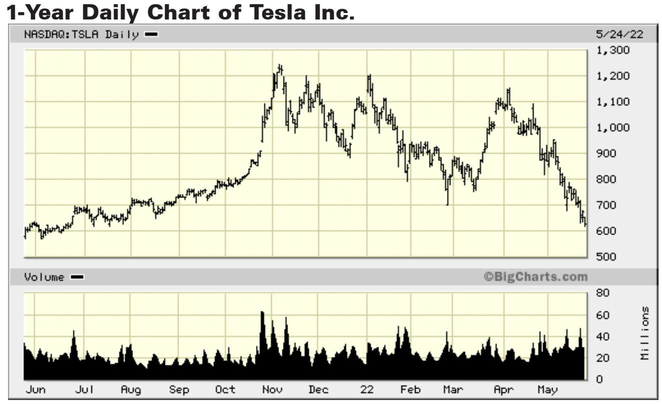

Chart provided by www.BigCharts.com

TWST: And you mentioned Gen Z and millennials. Would this be a good time, if they're not in the market, for them to maybe start to look for some opportunities? Especially since they have a long time horizon?

Ms. Prial: Absolutely. I'm very conservative when it comes to this. I think if you're just starting out in the market, you start out with index funds, with well-diversified index funds, and build a nest egg with consistent dollar cost averaging. I think now would be a good time to maybe go in a little heavier than you would normally just because we have seen so much pain in the marketplace. Dollar cost averaging, although it's not sexy, does work because that consistent purchase, consistent savings, allows you to accumulate that nest egg.

I also think it's fun as a new investor to take some money that you can afford to lose and to try your hand at a handful of individual stocks where you've done some research. It's more than just a tip that somebody whispered to you. You've looked at the balance sheet. You've looked at the cash flow statements. You've looked at the income statement. You understand the business. You think it's an attractive business and you have good reasons for that. Because it is fun — and it's how you get hooked on investing.

So to me, you take that barbell approach of a little bit of money that you can afford to lose to have some fun with individual stocks, a bigger pool of money to really accumulate the beginnings of that nest egg that you do in index funds, but take advantage of the fact that the market has not been working here, and absolutely stick your toe in.

TWST: Anything we haven't talked about you'd care to bring up?

Ms. Prial: I like ending on the note of just investing, because I really am very passionate about that. I think it's easy for individuals in particular to be afraid to jump in when things are ugly, and I wouldn't invest everything I have right now; but the idea that you just have to get started — and you like to buy when things are on sale — just like you like to buy clothes when they're on sale. The market is on sale today.

TWST: Thank you.

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