Needham Funds' First Quarter Call
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SPEAKERS

Kathleen Mumma
John Barr
Chris Retzler

PRESENTATION

Operator: Good afternoon and welcome to the Needham Funds' First Quarter Call. My name is Brandon and I'll be your operator for today. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session. [Operator instructions]. Please note this conference is being recorded. I will now turn it over to Kathleen Mumma. Kathleen, you may begin.

Kathleen Mumma: Thank you, Brandon. Good afternoon. Thanks, everyone, for joining us today. On our call we'll review the Needham Funds first quarter and our investment themes and our outlook for this year. Before we start, I'll announce our disclosures.

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With us today on the call are John Barr and Chris Retzler. John manages the Aggressive Growth Fund. Chris manages Small Cap Growth Fund, and John and Chris together co-manage Needham Growth Fund. It's my pleasure to turn the call over to John Barr.

John Barr: Hello. Our mission at the Needham Funds is to create wealth for long-term investors. The quarter had three themes. First was M&A. Nimble Storage and Norsat agreed to be acquired and were top contributors, and we believe there will be more small cap M&A throughout 2017. The second theme is the payoff. Entegris (ENTG) —the maker of filters and chemicals used in advanced manufacturing processes—showed very strong margins and benefited from investments made over the last three years and was one of the top contributors. The third theme is reinvestment opportunities by our companies. We love it when our companies have R&D opportunities with potential high returns. In the short-term, sometimes the market doesn't view these investments the same way we do. KVH Industries (KVHI) and Akamai (AKAM) both announced new product initiatives and the stocks were down. KVH Industries was by far the top detractor in the quarter.

The first quarter was positive for the Needham Funds, but not as positive as the markets. We believe this quarter creates an opportunity to invest in the Needham Funds. Underperformance by KVH, Akamai and to a lesser extent, a number of our top 10 holdings after a very strong 2016 performance, could position the Funds for a good 2017.

We're pleased to have available the Needham Funds' new Institutional Share Class, which was launched at the beginning of the year. The highlights of this class are: $100,000 investment minimum with aggregation permitted; no 12b-1 fees; an expense ratio capped at 1.40%; and tax-free conversions from the retail shares. Please refer to our prospectus for further information. The I-Shares are currently available for direct shareholders and also for sale on platforms at Fidelity, Schwab, Pershing, Raymond James, Wells Fargo and LPL. We're working to broaden distribution of these lower cost shares, and encourage you to contact your financial intermediary about when you might find them available.

Now turning to the quarter, in January the market rallied on President Trump's inauguration and thoughts of pro-growth tax reform, infrastructure spending and a reduced regulatory burden. The Russell 2000 was up small and the Needham Small Cap Growth Fund outperformed. The S&P was up near 2% and outperformed all three Funds.

In February President Trump promised a phenomenal tax plan and to streamline the new drug regulatory process. The Russell was up 1.9% while the S&P 500 was up 4%. The Funds underperformed in February.

March brought the failure to pass the first attempt to repeal the Affordable Care Act and to introduce new healthcare legislation, which brought worries that tax reform would be delayed. The indices were up small and the Needham Aggressive Growth Fund and the Needham Small Cap Growth Fund outperformed. Market volatility was low, as the S&P 500 only closed up or down more than 1% twice in the first quarter. We imagine that volatility could increase from this low level throughout the year.

Turning to the Funds - we'll now discuss the three Funds. I will start with the Needham Growth Fund and then the Needham Aggressive Growth Fund. Chris will discuss the Needham Small Cap Growth Fund and closing comments.

So the Needham Growth Fund returned 1.8% and the Institutional Class returned 1.9% in the first quarter, trailing the S&P 500, which returned 6.1%. For the quarter, Entegris was the top contributor and returned 31%. Entegris supplies filters and chemicals used in advanced manufacturing processes. Semiconductor plants require the equivalent of capturing one contaminated drop of water in a day's worth of water flowing over Niagara Falls, and its advanced manufacturing is necessary to make low power semiconductors, which are necessary to extend battery life in mobile phones. After several years of R&D and capacity investment and an astute acquisition, Entegris reported a strong 2016, including December quarter results with margins ahead of expectations. Thermo Fisher [Scientific] (TMO), the Fund's largest holding, was the second-leading contributor, as it reported strong margins and earnings.

The largest detractor by far was KVH Industries which was down 28.8%. KVH announced plans to bundle and lease its maritime antennas with entertaining and training content. Lease accounting could lower revenue in the short-term. The company is also the market leader and has sold over 500 fiber optic gyroscopes to the self-driving car market. KVH announced plans to lower the cost of fiber optic gyroscopes by an order of magnitude to maintain its market share lead as the self-driving car and drone markets take off.

The Needham Growth Fund's largest new position is comScore (SCOR), which is a key challenger to Nielsen in measuring television and internet video audiences. comScore is a year late filing its 2016 annual report, which has created what we believe to be an attractive entry price. We believe comScore will file its financial reports this summer and will get back on investors' screens.

We added smaller new positions in Xactly (XTLY), Clean Harbors (CLH) and Markel Corporation (MKL). The largest addition was to Oil-Dri Corporation of America (ODC), which owns clay mines used as absorbents including its cat litter. Other significant additions were to KVH Industries on its weakness, and to Pure Storage (PSTG).

The Needham Growth Fund sold its positions in Brooks Automation (BRKS), Nimble Storage (NMBL), which announced plans to be acquired by HP Enterprise, Tiffany (TIF) and Ultra Clean (UCTT). We also sold 10% of the Fund's largest position, Thermo Fisher Scientific, to manage the position size and 20% of its MKS Instruments (MKSI) position on valuation.

The Fund had an active share of 102.7% versus the S&P 500 and trailing 12 months turnover of just 4%. Active Share is a measure the difference of the holdings in the portfolio from its holdings in its appropriate passive benchmark, in this case the S&P 500. The Fund had 68% of invested assets in companies with over $2 billion of market cap, and the Fund's top 10 positions are 51.5% of net assets. The Fund had a 0.5% cash and a 4% short position.

Now turning to the Needham Aggressive Growth Fund, it returned 1.6% and the Institutional Class returned 1.75% in the first quarter compared to 2.5% for the Russell 2000. Like the Needham Growth Fund, Entegris was by far the top contributor in the first quarter. Norsat (NSAT)—a microcap maker of satellite communications antennas and other communication products—agreed to be acquired and the stock rose 27%.

Other top contributors included Apple (AAPL) and semiconductor equipment company, Nova Measuring Instruments (NVMI). Two of the top 10 contributors were short positions, as Ubiquiti Networks (UBNT) declined 13% on poor margin guidance. I continue to believe there are more severe issues with Ubiquiti than margins. Medallion Financial (MFIN) fell 34%, as the company defaulted on a bank loan and was sued by this lender. The value of medallions owned and collateral medallions continues to collapse as Uber and Lyft bring choices to consumers.

The Fund's largest detractor by far was KVH Industries. Akamai was the second-largest detractor and was down 10.5%. Akamai also reported that it will be investing in new products during 2017, and the market responded negatively. Akamai will be investing in cloud-based security and enterprise content delivery service offerings.

We added comScore and smaller positions in DIRTT Environmental (DRT), which manufactures prefabricated office interiors, Xactly Corp., which is SaaS for incentive compensation management, Pure Storage and Markel Corporation, which is an amazing specialty insurance company, which invests its float very astutely.

It was a very light trading quarter. Once again, we added to positions in Oil-Dri, KVH and GSE Systems (GVP). We did not exit any long positions and trimmed small amounts on just a few. We did exit the short position in Freddie Mac (FMCC). The Fund had an Active Share of 110.4% versus the Russell 2000 and training 12-month turnover of just over 1%.

The Needham Aggressive Growth Fund exited the quarter with 57% of assets in companies under $2 billion in market cap. The Fund's top 10 positions are 52% of net assets. The Fund had a 6% short position and 1% cash.

With that, I will turn it over to Chris to discuss the Needham Small Cap Growth Fund and closing commentary.

Chris Retzler: Thank you, John, and thank you, everyone, for joining us here today. I very much want to welcome many of our new investors. We had significant inflows in the end of the year and we have seen some inflows here in the first quarter as well. We've been out to meet with these investors and I just wanted to welcome them to the Fund and look forward to a long relationship with them.

The Fund this quarter returned 1.5%. The Institutional Class returned 1.6%, just slightly beneath the Russell 2000 total return of 2.4%. After substantial returns last year, we were very pleased with the performance for this quarter, as many of our holdings did not give back as much as what they could have after such great performance last year. We have returned to a more concentrated portfolio from where we were at the end of last year when we had a lot of funds come into the Fund, as well as dollars returned to us from the M&A market. The Fund ended the quarter with its top 10 holdings as 46% of the Fund, so getting back to our more typical 50%.

What we also were able to do throughout the quarter as we deployed capital in value opportunities was to get some greater diversification in the Fund across some different industries, beyond just technology where we have historically had much greater concentration.
The top contributors in the quarter were Nimble Storage, as John mentioned, was taken out by HP Enterprises, and we also exited the position as we felt it traded at deal price. Another top contributor was Ultra Clean Technologies, which was also a great contributor in 2016. It continued into the first quarter. Invuity (IVTY), which is a healthcare company, was the third top contributor. Then other names included The Trade Desk (TTD), EXACT Sciences (EXAS), Cohu (COHU) and Air Lease (AL). So we were very pleased that we had a distribution across different industries in the top contributing spots.

As John mentioned, one of the top detractors was KVHI, the others were Pure Storage and Amber Road (AMBR). But please keep in mind that Amber Road had a tremendous year in 2016 and is also going through some technical challenges right now, which we hope to see resolved over the next couple quarters.

Pure Storage is a great comp to Nimble Storage, which was acquired this quarter. It's now the top holding in the Fund and we think it provides great value on a three-to-one basis of $3 of upside to $1 of downside, and we're very excited about the position going forward for the remainder of the year.

So names that we added to the Fund - was a company called Twilio (TWLO), which went public last year. Another that's been under significant pressure in the market is Under Armour (UAA). We've also started a position in comScore, Akamai, Five9 (FIVN), Xactly, Mobile Mini (MINI) and Quantenna Communications (QTNA). So with the cash that we had at the end of year, we began to find some great opportunities and were able to deploy the capital to a level that gets the Fund more invested. We did exit positions in Entegris, Jabil Circuit (JBL), and as I mentioned, Nimble Storage.

In January, John and I were able to attend the Needham Growth Conference, where we met with many of the managements of our current holdings and potential new investments, and we were able to visit with about 50 of them, which is a great opportunity to get a start to the year. What we're seeing out there - certainly increased headline risk and increased market volatility, and we think that that should continue here through the remainder of the year. The expectations of lower regulations, tax reform, tax repatriation, and higher growth opportunities continue to support the market. However, the timing of these policies remain a key variable, and we continue to believe the timing is further into the future than the markets had originally expected back in November and December, but that creates the opportunity and the value opportunity to put money to work.

Earnings season has just begun and we expect earnings to be generally in line with some conservative guidance, as uncertainty around the timing of these pro-growth policies remain. We like individual stock stories and think active management will be important in a more volatile market. We prefer these higher active managements in our portfolios as we look for higher Active Share in our portfolio management.

As John mentioned, we also continue to see value in small caps and we think that the M&A market continues throughout the year. The high yield market remains healthy and healthier than it was this time last year as the energy market was just recovering from a sustained two-year downturn. So that generally gives good support to the small cap space where we have many of our investments.

With that, I'll turn it back to Kathleen for any questions.

Kathleen Mumma: Thanks, John and Chris. Brandon, we can take questions now.

Operator: Thank you. We will now begin the question and answer session. [Operator instructions]. We're standing by for any questions.

Kathleen Mumma: Thanks. While we're standing by, I had a couple of questions come over email. The first, "After such a great performance last year, why are you, John and Chris, still so bullish on small cap stocks?

John Barr: Well, maybe we can look at this a couple of ways. First is just looking broadly at the valuations of the stocks in the portfolio relative to the indexes. Many of our portfolios have superior revenue growth, cash flow growth, and trade at a discount to in line with many of the market indexes. So we still see strong value in the portfolios as a whole.

Secondly, if you look at the top 10 holdings, which are so important to us,—they had a significant contribution in 2016, but in the first quarter, six or seven of the top 10 were down in each of the Funds despite a reasonable performance. And as I emphasized, KVH and Akamai were down 29% and 30% because they're making investments. So we think that the valuations are attractive and the first quarter was a bit of a pause for many of the companies. Chris?

Chris Retzler: Yes. I think many of our top holdings continue to remain in very bullish upward patterns. They did correct in the first quarter, but where we saw a lot of contribution to the upside was in some of our smaller positions where we were more diversified. Again, our top holdings here, we still feel strongly on their long-term growth prospects, and we think that as more certainty comes about with what occurs in D.C., we think that our companies will be in great positions to benefit.

Kathleen Mumma: Thank you. The next question I had from email was, "Do you see any upcoming consolidation in the ad tech (digital advertising) space?"

John Barr: Well, the digital advertising market has been a very difficult one for companies that have gone public. Very few of them have produced—have met their business models and produced positive returns for investors. So as we look backward, there have been a fair number of acquisitions by larger companies of ad tech companies. We'd expect that that would continue.

From our perspective, the three Funds are all invested in The Trade Desk, which is an advertising technology company with a different approach. They work closely with the advertising agencies rather than trying to arbitrage the agencies out of the picture. So The Trade Desk gets a software license fee for the use of their software, rather than trying to be a marketplace matching buyers and sellers of ads. So it's a different model. We think it could be the winner or one of the winners in this market. But beyond that, we do think there's a positive outlook for M&A. I'll turn it over to Chris.

Chris Retzler: Yes. It's always very hard to predict what the M&A market will look like. I think what management teams try to decide is the difference between building and buying. There are activists in a lot of the names in the ad tech space. So there's certainly the potential for something to happen. The alternative for them could be that they would maybe go back to being private companies in residing outside of the public markets would be another alternative to acquisitions.

Kathleen Mumma: Thank you.

Operator: And we have no questions on the phone at this time.

Kathleen Mumma: All right. Well if anybody comes up with any questions in the meantime, please call us or email us. We're happy to speak with you. Thanks again for dialing into our call today and we wish you a great second quarter.

Operator: Thank you. Ladies and gentlemen, this concludes today's conference. Thank you for joining. You may now disconnect.