Needham Funds Second Quarter Call
July 24, 2017, 2:30 PM ET

SPEAKERS
Kathleen Mumma
John Barr
Chris Retzler

Operator: Welcome to the Needham Funds Second Quarter Call. My name is Eric and I'll be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session. [Operator instructions]. Please note that this conference is being recorded. I will now turn the call over to Kathleen Mumma. Please go ahead.

Kathleen Mumma: Thank you, Eric. Good afternoon and thanks to all for joining our call today. We'll review the Needham Funds second quarter and our investment themes and outlook for 2017. Before we start, I'll announce our disclosures.

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

John Barr: Our mission at the Needham Funds is to create wealth for long-term investors. This quarter had top performance from some of the small cap, smaller holdings that you don't hear much about. Corium International (CORI) +79%, comScore (SCOR) +22%, Nova Measuring Instruments (NVMI) +19%, to name a few of the top ten performers.

I wanted to highlight a couple of things that occurred during the quarter. We travel a lot for research and I wanted to highlight three of my recent trips. A few weeks ago, I attended SEMICON West in San Francisco and met with many semiconductor equipment and service companies, including [Fund] holdings: PDF Solutions (PDFS), MKS Instruments (MKSI), Nova Measuring, Applied Materials (AMAT), Entegris (ENTG) and FormFactor (FORM). And, I concluded that the replacement of disk drives by NAND memory semiconductors could provide growth for our companies for a number of years to come.

In June, I attended an event at the DIRTT Connext User Conference in Chicago. DIRTT Environmental Solutions (DRT) is a small cap holding of the Needham Aggressive Growth Fund. The company has the most amazing computer-rated design system that's used to design building interiors, produce some building materials and then send the manufacturing files to DIRTT plants, where they produce the interiors. It saves significant time and waste on a construction site, and this really is likely to be the future of interiors construction.

In May, I attended the Berkshire Hathaway annual meeting and associated dinners in Omaha. The day of the meeting, I was up at 4:30 am to get in line for a seat in the CenturyLink Center. It was amazing to see Warren Buffett and Charlie Munger answer shareholder questions all day long. It's obvious, but I was struck by their steady optimism. They talk like business people and company owners, rather than stock traders.

At a dinner, I learned about a microcap, Ecology and Environment, Inc. (EEI), of Lancaster, New York, which matches our criteria of a strong management team, big market and growth opportunities, and available at a reasonable price. After fundamental research this quarter, Ecology and Environment is a new holding of the Needham Aggressive Growth Fund.

I'd also like to highlight the concept of Active Share, which we've talked about on these conference calls, and how it relates to the Funds' top ten holdings in volatility. Active Share is a measure of the difference of the holdings in a portfolio from the holding in its appropriate passive benchmark. The Active Share concept was developed in a working paper in 2006 by Martijn Cremers and Antti Petajisto. Funds with an Active Share of 100 have no similarity to an index, while zero indicates perfect similarity to an index. Cremers, Petajisto, and later Ankur Pareek showed that access returns were correlated with high Active Share funds.

It makes sense that a concentrated fund has the chance to outperform an index, as long as the stocks are the right stocks. It's also intuitive that these portfolios could be more volatile to the down side. In "Patient Capital Outperformance, the Investment Skill of High Active Share Managers Who Trade Infrequently," Cremers and Pareek concluded that over the 30-year period of their study, all of the managers' alpha came from funds in the top quintile with high Active Share and low turnover. To be in the top quintile required Active Share of 92%.

The Needham Funds have Active Share of well above 92%, due to the concentration of the top holdings and due to the short positions. Over the last five years, the Needham Funds have had approximately 50% of net assets in their top ten holdings, which makes for a high Active Share and gives us the chance to outperform, but also the chance to underperform.

In 2016, the Funds benefited from the outperformance of top ten holdings, such as PDF Solutions +108%, KVH Industries (KVHI) +25%, and Newport Corp. (NEWP) +45% on a takeover. As of June 30th, this year, PDF, down 27%, and KVH, down 19%, have been detractors. We believe this underperformance in the stock prices could create an opportunity to invest in the Needham Funds. I look at these companies as compounders with a plan to hold them for years.

We're pleased to have available the Needham Funds new institutional share class, which was launched at the beginning of the year, symbols NEEIX, NEAIX and NESIX. The highlights are its $100,000.00 investment minimum, with aggregation permitted; no 12b-1 fees; and expense ratio capped at 1.40%; tax free conversion from the retail shares. Please refer to our prospectus for details. 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, and 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.

Turning to the quarter, in April, the averages were positive and so were the Needham Funds. The preliminary GDP showed just 0.7% economic growth, although that was later revised to a still low 1.2%. The Atlanta Fed's GDPNow forecast shows preliminary second quarter GDP growth at slightly higher than 2.5%, making the first half of 2017 consistent with growth of the last eight years. In May, the averages were mixed and the Needham Growth Fund and Needham Small Cap Growth Fund outperformed. May brought the firing of FBI director James Comey and North Korea's third missile launch. June saw the averages up and the Needham Small Cap Growth Fund outperforming. June saw a selloff in the FANG (that is, Facebook, Amazon, Netflix, Google Alphabet) stocks, that lasted all of a little more than a week. Market volatility is low, as the VIX is close to the lowest on record. We imagine that volatility could increase from this low level.

Now turning to the Funds, we'll now discuss the three Funds. I'll 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 2.24% and the Institutional Class returned 2.35% in the second quarter, trailing the S&P 500, which returned 3.09%. For the quarter, long-time holding and largest position Thermo Fisher Scientific (TMO) was the top contributor by far and returned 13.7%. Thermo Fisher develops instruments and consumables used in life science and other research-oriented industries. Thermo had good growth in its pharma and biotech markets and strong margins.

Corium International was the second leading contributor. Corium is developing a patch-based drug delivery system. They had favorable results on their Donepezil drug compared to oral Aricept, which is the market leader for Alzheimer's.

The largest detractor was PDF Solutions. PDF's gainshare royalty revenue was below the estimates of the two analysts following the company. Most importantly, we are invested in PDF for the Design-for-Inspection System, which is sold to semiconductor design and manufacturing companies to determine whether leading edge semiconductors can be manufactured with high yield. PDF made significant progress with DFI. We took advantage of the weak stock price and added to our position.

The Needham Growth Fund added a beginner position in Coupa Software (COUP), which is a SaaS, software-as-a-service product used for spending management. They benefit from a network effect from purchasers and their suppliers being on the system. We also added to KVH, Photronics (PLAB), Agile Therapeutics (AGRX), Reis (REIS) and comScore on price weakness.

The Needham Growth Fund sold its position in Jabil Circuit (JBL), as it hit our price target, and Xactly (XTLY) with its sales compensation tracking and management SaaS, due to its impending sale to Vista Equity. We're sorry to see Xactly go; we feel they had years of growth ahead. We sold nearly 20% of the Fund's position in Express Scripts (ESRX). We also, again, sold 10% of the Fund's largest position Thermo Fisher, to manage the position size, and 10% of the Becton Dickinson (BDX) position on valuation.

Turning to the Needham Aggressive Growth Fund, the Fund returned -0.4% and the Institutional Class returned -0.26% in the second quarter, compared to a +2.46% return on the Russell 2000. In the second quarter, six of the ten largest positions of the top ten were down. I'm mostly concerned when something fundamental has changed relative to my investment thesis and a decline in the quarterly stock price will often present an opportunity to build the position.

Corium International was the top contributor. Reis, Inc. returned 20%, was the second largest contributor. Reis is a top ten [holding] and it sells information to real estate investors, institutional investors. At the beginning of 2017, Reis added more detail to its student housing product, and we believe Reis' subscription revenue can grow double digits in the third and fourth quarter 2017, which could be positive for the stock. Longer term, we believe new products may help Reis return to double digit revenue growth and 40% operating margins.

Cryoport (CYRX) is a new position within the quarter and was a top ten contributor. Cryoport supplies cold chain logistics for biopharma, in vitro fertilization in animal health. They ship biological samples at temperatures down to -180 degrees C. They've been selected by most of the very high value CAR-T anti-cancer drugs, which the FDA is giving fast track to market. Customers include Kite Pharmaceutical and Novartis; they've been selected by 28 out of the 30 companies that have trials in this area. Cryoport returned 108% during the quarter and exited the quarter as a 0.6% position.

The Fund's leading detractor by far was PDF Solutions; we took advantage of the stock price weakness and added. Akamai (AKAM) was the second largest detractor. They reported that they'll be investing in cloud-based securities and enterprise content delivery services and the market responded negatively. We added to the position.

We also added starter positions in Coupa Software and Ecology and Environment, and it was another very light trading quarter. We added to, in addition to PDF and Akamai, comScore, Vicor (VICR), DIRTT, GSE Systems (GVP), and Reis on weakness. We exited Thestreet.com (TST) - it just didn't work - and Xactly on its takeout.

We'll now turn over to Chris to discuss the Needham Small Growth Fund and closing commentary.

Chris Retzler: Thank you, John, and thank you, everyone, for joining us here today on our quarterly call. Overall, we were very pleased with the performance of the Small Cap Fund this past quarter. What we found was our management teams continued to focus on their long-term business plans, while simultaneously achieving leverage in their business models. The first quarter, we saw some dip in stock prices post- inauguration, which began to recover at the end of the quarter and continued through the second quarter, and here into the summer months.

The Fund for the quarter returned 5.4%, the Institutional Class 5.5%, while the Russell returned 2.5%. And year to date, the Retail Share Class returned 7%, the Institutional 7.3% approximately, and the Russell 2000 is up 4.99%.

Our top ten holdings represented over 50% of the Fund. As we had mentioned earlier in the year, we had received back some funds from some M&A transactions last year and we were looking for opportunities to deploy that capital. We did that quite a bit through the quarter and ended the quarter with a cash position around 3%. Some of the top holdings that represented in the fund at this point are Pure Storage (PSTG), Amber Road (AMBR), PDF Solutions and FireEye (FEYE). We were able to add to some of these positions through the quarter, as well as the performance that they got with the stock prices rising and thereby becoming more concentrated.

As John described earlier, we have begun to focus more on our Active Share number and the benefit that that has relative to the overall market. The Fund had an Active Share of 98.9% [at the end of the] quarter, while at the same time having a beta of 0.84%. The top contributors in the quarter were Pure Storage, Corium, FireEye, Reis, and Amber Road. Some detractors, as John mentioned, was PDF Solutions, a long-time holding and a holding that we feel very comfortable with going forward here, and quite frankly, into the second half we're very excited about. Another long-term holding that detracted in the quarter was Frequency Electronics (FEIM). Although there have been some announcements from the company recently, it makes it a little bit more beneficial here in the near- term. Another holding, Photronics, (PLAB) and Navigator Holdings (NVGS) also detracted, but again we have very long-term views on their futures.

We added two new positions to the portfolio, one named Analogic (ALOG), which makes detection equipment, which is being utilized in many of the airports. They've just signed a new sales agreement with a large airline and we think there will be more for that. Another [stock] that we've been in, in the past, but have returned to is Infinera (INFN)], and we're very excited about their new product launches that are going to be occurring here in the second half.

We did exit a handful of positions. We saw that our semi cap equipment had returned very nicely over the last 24 months. We took the opportunity based upon valuations to exit some of those positions. One name that's been in the Fund for a significant amount of time and now has been closed out is Ultra Clean Holdings (UCTT). Two others are Cohu (COHU) and Veeco Instruments (VECO). We also had two names that were acquired, and so we exited the positions. Those names were Invensense and Xactly, which was a new holding, but was acquired quite quickly in our investment period.

So, overall with the market, what we're seeing is the market volatilities remain low and this has been supporting valuations and multiples year to date. We believe this volatility has been held down by the accommodation of the central banks, which we think continue to remain in place at least for the near term. The high yield market is also supportive of small cap stocks, as it is a comparative asset class and continues to find new year highs here, even in the last couple of weeks.

We continue to see value in small cap stocks and we expect M&A to continue as larger companies deploy their capital and look to buy growth versus build. We also have expectations of lower regulations, potential tax reform, tax repatriation, which should drive higher growth opportunities for many of our companies. We're certainly in an environment that is more business friendly than what we've seen for the previous eight years. The one big question mark is the timing of when these policies may come through, and so that needs to be factored in and we think that where the market is, these changes may be a little bit sooner and we think it's further out in the future, but something will happen.

Earnings season has just begun and so far what we've seen has been good. We expect earnings to continue to remain constructive and we continue to like technology as a great bright spot, as there are many cycles and opportunities that continue to grow, no matter really, who won the White House. So, we continue to look for companies with great technological moats that can compete on the global scale, and defend their business positions, and maintain their margins as best they can, as long as they can.

Three themes that we continue to focus on, and we think are there for a long time, is cyber security; also next generation networking, storage hardware and infrastructure; and then the ability to move that data around. We also expect to see over the next couple of years a modernization of our military and defense. We think that we're well positioned in a handful of names to capture that spend that we expect out of the government. So, with that, I'll turn it back to Kathleen and open it up for any questions.

Kathleen Mumma: Thanks, Chris, and thanks John. Eric, we can open the lines up for Q&A.

Operator: We will now begin the question and answers session. [Operator instructions].

Kathleen Mumma: We can wait a couple more seconds in case anybody has a question. One that somebody sent to me was, "How do you expect potential tax reform to impact the companies in the portfolio?" So, maybe Chris, or John, you can speak to how our impending tax reform situation might affect the small cap companies?

Chris Retzler: I think that probably the greatest one would be tax repatriation of cash held overseas, and once that tax is reformed, we think that there will be a significant amount of capital back on shore that could lead to M&A activity. We would expect to see the redeployment of that capital through the acquisition of small and mid-cap companies that we think that would, one, put a floor into many of the valuations of the companies, as well as we would probably see an increased activity as they buy that growth.

John Barr: Also, many of the smaller companies are full tax payers at 35% to 40% rates, and they would clearly benefit from any reduction in rates. But it's a pretty theoretical question at this point.

Kathleen Mumma: Great, thank you. I also had somebody email me and said that they are having technical difficulties, they got hung up on when they tried to ask a question. So, if anybody does not have any more questions in the queue at this time, you're always free to call or email us with any questions. We're happy to speak with investors and financial advisors anytime.

Operator: We have no questions at this time.

Kathleen Mumma: Okay, well thanks, everyone, for dialing in to our call. We appreciate your time and again, anything comes up please email or call us. Thanks so much and have a great day.

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