Needham Funds Third Quarter Call
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SPEAKERS

Kathleen Mumma
John Barr
Chris Retzler

Operator: Welcome to the Needham Fund Third Quarter Call. My name is Karen and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Please note that this conference is being recorded. I will now turn the call over to Kathleen Mumma. Kathleen, you may begin.

Kathleen Mumma: Thank you, Karen. Good afternoon and thanks to everyone for joining our call. Today we'll review the Needham Funds' third quarter, our investment themes, and our outlook for the remainder of this year. Before we start I'll announce our disclosures.

The information presented on this call is not intended as personalized investment advice and does not constitute a recommendation to buy or sell a particular security or other investment. Please read the prospectus carefully and consider the investment objectives, risks, and expenses of the Funds before you invest. The prospectus contains this and other information about the Funds and can be obtained on our website, www.needhamFunds.com Investment returns and principal value will fluctuate and when redeemed, shares may be worth more or less than their original cost. Shares held 60 days or less are subject to a short-term redemption fee of 2%. Past performance does not guarantee future results and current performance may be higher or lower than these results. Performance current to most recent month-end may be obtained by calling our transfer agent at 1-800-625-7071.

With us on today's call are John Barr and Chris Retzler. John manages Needham Aggressive Growth Fund, Chris manages Needham Small Cap Growth Fund and together, Chris and John 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 and the third quarter was a good quarter for the Needham Funds and for small caps. The third quarter started with the rebound from the surprising Brexit vote and the Federal Reserve, once again, postponed hiking rates at the July, August, and September meetings. All three Needham Funds had positive returns each of the three months of the quarter.

The Needham Small Cap Growth Fund returned 12.3% and was ranked the number one small cap core Fund by the *Wall Street Journal*. The Needham Aggressive Growth Fund returned 9.3% and was ranked the number five mid-cap growth Fund. The Needham Growth Fund returned 6.0%, outperforming the S&P 500 which returned 3.9% and the Russell 2000 did return 9.0% during the quarter.

We believe this is a great time to invest in the Funds and in small caps. Although we believe the Fed may finally increase rates by 25 basis points in December, we believe interest rates and accommodative monetary policy are likely to persist for a long time. International monetary policy stayed very accommodative as approximately 40% of developed world sovereign debt trades at a negative yield. It sounds like a good time to be in the right equities.

Historically, small caps have outperformed the S&P, yet they've underperformed for over two years. We remain focused on our individual companies and see growth prospects and compelling valuations in our holdings.

We recently wrote *The Growth Factor #23*, looking at the role of founders, family, and long-tenured management [and] looking at some of the compounding investments in the Funds. I addressed the question, "Does extreme compensation create extreme risk?" My answer was, if you have to ask the question you've already lost. We featured PDF Solutions (PDFS), IPG Photonics (IPGP), ViaSat (VSAT), Super Micro (SMCI) and Oil-Dri (ODC) as some of our founder-managed companies and all of these are long-time holdings and are familiar to our investors.

Turning to the Funds and the quarter, the fear from the beginning of the year has faded. July started with the market rebound from the Brexit vote, the Funds returned 3.6% - 5.2% with the S&P returning 3.7% and the Russell 6.0%. July brought the failed coup in Turkey, violence in Europe, and the Presidential conventions, yet the markets moved forward.

Importantly, second quarter U.S. GDP growth was announced at 1.2%, and the first quarter revised to an anemic 0.8%. In August the Funds returned 0.8% - 3% while the S&P returned 0.1% and the Russell returned 1.8%. Interestingly, volatility decreased as August 31st was the thirty-eighth straight day with less than a 1% change in the S&P 500, and Chairman Yellen did indicate that economic conditions may be right for an increase in September.

September brought nice outperformance by the Needham Funds in the quarter. Two of our small-cap stocks, Hutchinson Technology (HTCH), returned 165% in the quarter as its acquisition by TDK [Corporation] was approved, and PDF Solutions, a major holding across the Funds, returned 8.5%. No surprise the Fed decided not to raise rates and won't do so in October, so talk is rates will be raised in December.

The leading contributor across the Funds was PDF Solutions which returned 29.9%. We think the market is just beginning to understand PDF's growth opportunity. The company will host its first investor day on November 1st since going public in 2001.

The quarter was also characterized by broad strength across our holdings. Five other familiar investments were major contributors across the Funds. Amber Road (AMBR) returned 25.2%, it will benefit from trade complexity with Brexit and China. FormFactor (FORM) returned 20.7%, MKS Instruments (MKSI) 15.9%, KVH Industries (KVHI) 14.4%, and Entegris (ENTG) 20.4%.

The leading detractors across the Fund were Super Micro Computer down 6%; this was the second quarter in a row of pre-announcements, they had several competitive losses in the data center market. Express Scripts (ESRX), down 7%, and Reis, Inc. (REIS), down 17%.

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

The Needham Growth Fund returned 6.0% in the quarter, beating the S&P 500 which returned 3.9%, and trailing the Russell 2000 which returned 9.1%. FormFactor was the top contributor, PDF Solutions was the second-largest contributor. The largest position in the Fund is Thermo Fisher Scientific (TMO) and it was the third leading contributor; they closed their accretive acquisition of FEI Company.

The top detractor was the Fund's short position in Ubiquiti Networks (UBNT), which appreciated 38.4% during the quarter. I'll talk about it more when I talk about the Aggressive Growth Fund.

Express Scripts was the second leading detractor as it was down 7%, but the quarter brought slightly lower gross margin in volume growth. Express continues to be in a lawsuit with Anthem, its largest customer. Anthem's proposed merger with Cigna was broken up during the quarter, we think this will get Anthem back to the table with Express Scripts and a sound commercial continuation will prevail.

The Needham Growth Fund added new positions including The Trade Desk, Inc. (TTD) and Nutanix (NTNX) which were IPOs, and Pure Storage (PSTG) and Navigator Holdings (NVGS) which are also held by the Small Cap Growth Fund.

The two largest additions were to Reis, Inc. on disappointing earnings, and to PDF Solutions. The Fund exited its position in Silicon Graphics (SGI) as the company is set to be acquired by Hewlett-Packard; and reduced positions in FormFactor, Nova Measuring [Instruments] (NVMI); and trimmed positions in Thermo Fisher, Becton Dickinson (BDX), CarMax (KMX), Varian Medical (VAR), and Entegris on valuation and to manage position sizes. These are all long-term Fund holdings.

The Fund had an Active Share of 106.4% versus the S&P 500 and trailing-12-month turnover was just 8%. Active share is the measure of the difference of the holdings in a portfolio from the holdings in its appropriate passive benchmark, in this case the S&P 500. The Fund had 68% of assets invested in companies over $2 billion in market cap. Top-ten positions were 52.5% of net assets. The Fund had 1% cash and 6% short position.

Turning to the Aggressive Growth Fund, returned 9.3% in the third quarter, outperforming the Russell 2000's 9.1% and the S&P 500's 3.9%. Top contributor was PDF Solutions which is now the largest position in the Fund. We remain quite optimistic about their outlook.

Second top contributor was GSE Systems (GVP) which returned 29.6%; it exited the quarter as the number five holding in the Fund and a 5.2% position. This is an undiscovered micro-cap. They supply simulation and training for the power and process industries. I think the new management team will be able to transform the company to a high-margin software and services company.

The third leading contributor was long-time holding Entegris. They make filtration systems and supply chemicals to semiconductor and other industries. They reported strong margins in the quarter. And then, it was the companies mentioned earlier, FormFactor, KVH Industries, and Amber Road, and then finally Apple (AAPL), which were the leading contributors.

Leading long detractor was micro-cap Reis, Inc., the real estate information company. They reported a slower growth rate than had been reported in the last few years. We believe their new products may lead to surprising growth.

The Fund's short position in Medallion Financial (MFIN) was a top contributor as stock fell 42.2%. The company cut its quarterly dividend from $0.25 to $0.05 a share. We continue to believe that many of their assets are worth far less than what they're being carried for on the balance sheet. Chicago [taxi cab] medallions are seeing limited buying and selling at around $60,000 while carried at over $200,000. New York [City] taxi cab medallions can be had for $250,000 yet they're carried at over $600,000.

The leading detractor was the Fund's short position in Ubiquiti Networks. Ubiquiti recognizes revenue on selling to its distributors. In the June quarter, South American revenue was up 54% over the March quarter. They have one particular distributer in Paraguay that is the bulk of this. We note that the company's new chief accounting officer is on Long Island, the leading distributer is in Paraguay, the cash is in Hong Kong, and the headquarters is in San Jose. It's a pretty complex structure.

We added Agile Therapeutics (AGRX), which is developing the Twirla contraceptive patch. We own Corium International (CORI), which is the patch's R&D and manufacturing partner; and also the IPOs, Trade Desk and

Nutanix. We added to [our existing positions in] Reis, GSE Systems, and Corium. We exited FEI [Company] on its acquisition by Thermo Fisher, and Silicon Graphics on its pending HP acquisition. And then we've reduced a number of positions including FormFactor, Frequency Electronics (FEIM), and Entegris for tax planning and position sizing.

[The Fund had] Active Share of 116.3% versus the Russell 2000 and trailing-12-month turnover just 11%. And, we exited the quarter with 61% of assets in companies under $2 billion. The Fund's top ten positions are 54.1%, 9% short position, and once again, fully invested.

With that we'll turn over to Chris to discuss the Needham Small Cap Growth Fund, macro, and closing commentary.

Chris Retzler: Thank you, John, and thank you, everyone, for joining us today. The third quarter was a very nice quarter for the Fund as we continued to see great performance from many of our small cap companies. The Fund returned 12.3% in the quarter and is up 21.8% year-to-date.

Many of the names that we've spoken of over the last few years have really begun to shine this year and have contributed to the performance in the Fund. Three top names that contributed in the third quarter is a long-time holding, Ultra Clean Technologies (UCTT), which is exposed to the semi-cap equipment space which we are exposed to across many names and we feel still has a good runway here into the year end.

Amber Road is also a name which had detracted from performance in 2015 and has come back very strong here in 2016, and as John mentioned, had some very nice fundamental drivers behind it as it helps to simplify the process of trade. And, as things as Brexit and other trade deals go on, they should stand to benefit with their customers adding this technology.

Another name is Hutchinson Technologies, which had been a detractor in the second quarter, came back and did get approval on their [acquisition] transaction, which provided a very nice return in the quarter and since has closed. We also were very active in the quarter in adding some new positions, although not large positions at this point, but we have been trying to redeploy a lot of the capital that has been returned to us from deals like Hutchinson and Newport Corporation (acquired by MKS Instruments in April 2016) which were substantial positions.

Two names we'd like to highlight are Pure Storage and Nimble Storage, which are both focused on the next-gen storage area. We think that they have nice long-term runways and we would be continuing to monitor those stock prices as opportunities arise.

We also added a company called Core Laboratories (CLB), which is a high-quality servicer into the oil and gas space. What we've seen is a recovery in the energy space, but Core Labs really is a technological innovator to drive the efficiencies in the oil fields.

We also were able to participate in two IPOs that we have held the positions here. We're very excited about the The Trade Desk and Nutanix. It's been a while since we've begun to see these types of transactions in the marketplace and so we're excited that the IPO market is delivering higher quality companies that we can participate and have substantial positions in going forward.

Two names that we did exit in the quarter are Barracuda Networks (CUDA) which began to hit our price targets and we felt valuation levels had been achieved for what we had gone in on. Another long-time holding which we've spoken about, but we've taken the opportunity here based upon a substantial move off of its lows, is TTM Technologies (TTMI). It's been going through the integration of its acquisition of Viasystems, and it's been a few years that we've been very patient to see that recovery back to the levels, and we felt that it was an opportune time to take our money off the table.

We did end the quarter with a higher level of cash than normal, but we also ended the quarter with a higher level of shorts, where we do feel volatility here should be at heightened levels going into the October and November quarters. We feel that the markets have been driven higher due to low global interest rates as a result of the accommodative monetary policy. This has had the effect of lowering volatility and allowed for multiple expansion.

Although we don't expect the Fed to move before December, we're also being moved around by global central banks and what their plans may be. Throw in the election that's coming up here and we see a significant amount of uncertainty which could drive that volatility to increase and, thereby, we could see multiple compression. So being that we're a long/short Fund, we've taken advantage of that opportunity to put out some shorts and try to capture and protect to the downside as we've had a great year and we'd like to protect some of that.

Earnings season has begun here, although there's been some negative surprised in both the industrial, healthcare, and now technology sectors. We believe the current slow growth environment is weighed down by excessive regulation in the government. That said, we do like individual stock stories and think that active management is the best way to capture that, but with a hedge to balance the risks of a market correction. We see value in small-cap stocks and we also see the M&A market still quite active, and we think that a handful of our names in our portfolio would be nice acquisition targets for larger-cap companies.

We also feel comfortable in the small-cap world as the high-yield market is healthier than it was last year, when it was under great duress by the energy market collapsing, causing most of the high-yield market to implode. Typically, the high-yield market is an asset class that competes with the small-cap dollars going into it based upon its proximity and behavior between a bond and equities. Again, we stick to our knitting and we're still highly concentrated at 47% of our top-ten holdings, and we think technology's still a good value investment across the board.

One area that we had seen earlier in the year that had hurt us but we think is beginning to look up was the limited enterprise spending, as CFOs were looking to cut back and make their quarters. There's only so long that they can postpone those investments and we think that should begin to come through here, and that would benefit many of our names, two of which I mentioned was the Nimble and Pure Storage.

With that we'll conclude the conversation and we look forward to you on the next conference call.

Kathleen Mumma: Thanks, Chris. Thank you, John, and thanks to everyone for dialing in today. If you have questions or comments please contact me. John and Chris always make time and would be happy to speak with investors like you. So, thank you and have a great rest of your year.

Operator: Thank you, ladies and gentlemen, this concludes today's conference. Thank you for your participation. You may now disconnect.