Dynamic Growth Opportunities (DGO)

Strategy Update Through September 30, 2019

Firm Overview

SWS Partners is a registered investment advisor that focuses on using technology to deliver contemporary asset management and financial planning solutions to high net worth individuals, family offices, endowments, foundations, and other institutions. We believe that by emphasizing the application of modern technologies we can create broad efficiencies and deliver better outcomes to clients.

Strategy Info

Inception	May 1, 2018
Benchmark	Russell 1000 Growth Index
PM	Michael Parker, CFA

Strategy Objective

DGO seeks to create long-term capital appreciation by investing in companies across multiple industries that have the ability to maintain or take a profitable market share.

Portfolio Manager

Michael Parker, CFA, is the CIO of SWS and portfolio manager for the DGO Strategy. Before joining SWS in 2017, Mike was a portfolio manager of $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS). He leverages over 17 years of experience on both the buy-side and sell-side to bring an institutional research and portfolio management framework to SWS Partners.

Prior to OPERS, Mike was responsible for investment bank equity research at FBR Capital Markets. He received his bachelor of science in economics, finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

Third Quarter Update

Having crossed into “longest bull market in history” territory earlier this year—the exact cross-over point dependent upon one’s definition—the current environment tends to be a powder keg for fearmongers. Any economic data point surfacing with the faintest hint of negative interpretation becomes a smoking gun for the long-overdue downturn. This is not to say we’re declaring “clear skies,” nor is there any shortage of overhangs capable of festering into debilitating wounds that could impair economic growth. However, for various reasons that we’ll explore, it’s possible that the public equity markets might not be the primary victim to a pricing correction. Rather, evidence of a bubble that has yet to pop entirely, but undoubtedly has started to lose pressure, might be on the fringes of the public markets, namely large private companies eyeing to go public or those who recently have listed.

One downside risk of an entire decade of cheap funding is deep pockets capable of fueling sizable opportunities, causing the universe of venture-backed, privately-held companies to swell to disproportionately large sizes. Instead of having thousands of discerning eyeballs scrutinize aspects such as corporate governance and product safety, these “decacorns” (i.e. unicorns with valuations >$10 billion) are discovering landmines further into their business maturation. The size of this cohort is also noteworthy; today’s decacorns in aggregate rival that of J&J, Walmart, or JPMorgan: at the beginning of this year, decacorns totaled approx. $362 billion in valuation (see chart 1 on page 2). This is out of a current unicorn total universe of $600 billion across 187 private companies, per PitchBook. Dislocations have occurred over the past few months that have the appearance of idiosyncrasy at first glance: WeWork’s IPO gets shelved and management shake-up ensues, Juul’s CEO steps down amidst product safety concerns, Uber and Lyft go public followed by escalating cash burn concerns. However, in aggregate, the ripple effect causes increased pricing scrutiny to private companies hoping to follow suit in 2020. Today, valuations of the decacorns, as a whole, are roughly 17% lower than they were in the beginning of the year. Those investors with their eyes locked on the public markets, anxiously awaiting a correction, may have missed this private market dislocation or failed to note the 20% peak-to-trough correction in the public markets during Oct-Dec 2018.

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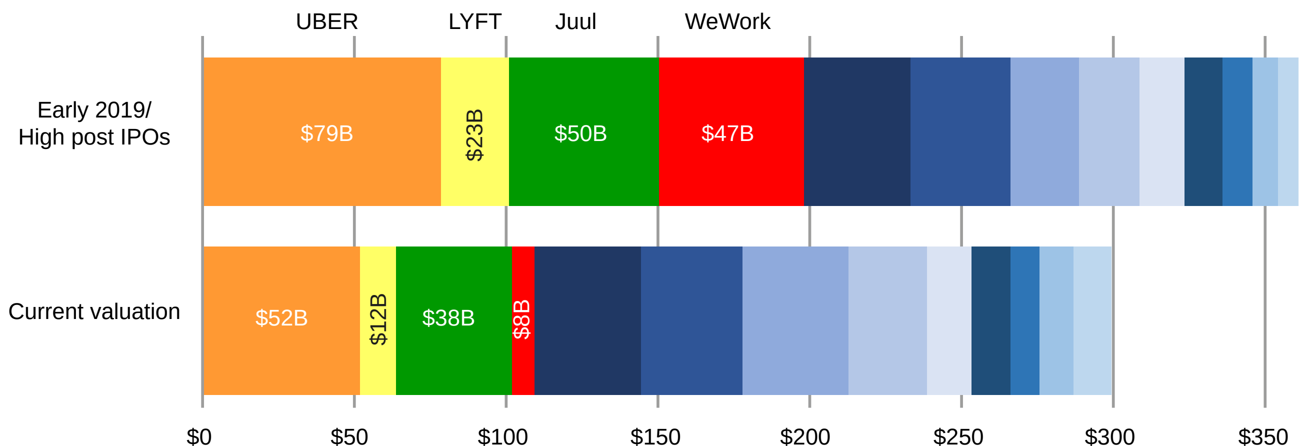
Chart 1: Decacorns + Uber, LYFT ($B)



Source: WSJ, CNBC, Forbes, FactSet

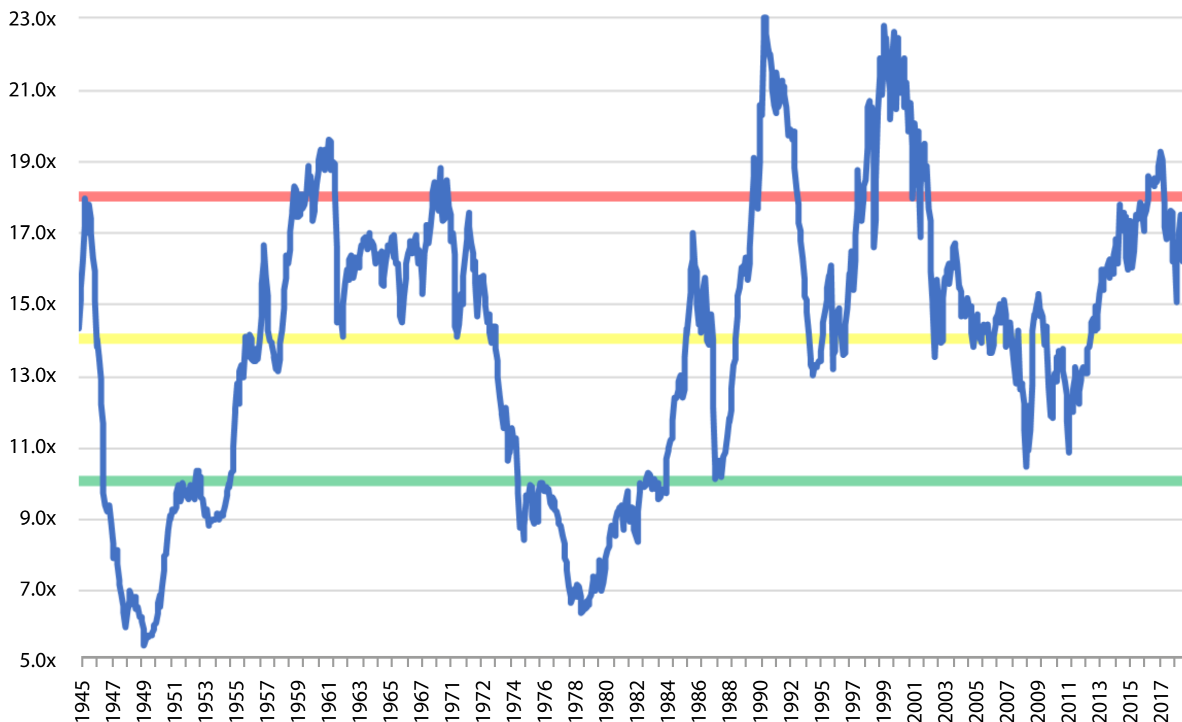
Turning our sights onto the public markets, let's first consider why bull-run duration alone is a foolish factor to scrutinize in the effort to prepare for and to identify future market corrections. Since the equity markets are solely tasked with pricing future outcomes impacting cash flow generation, there is zero regard for nostalgia on the past. Tomorrow's performance in the S&P 500, or any other broad equity index, will have no concern for the quantity of days since the financial crisis. This underscores the importance of studying how today's prices reflect the forward expectations that they attempt to reflect. One market valuation metric gathering interest of late is total market capitalization to US GDP.

Market cap, the numerator in the aforementioned formula, reflects collective efforts to price all opportunities of US-listed companies, both their domestic- and international-sourced endeavors, whereas the denominator solely captures economic output within US borders. The problem with viewing this metric in isolation resides in the fact that many multinational companies own foreign-based subsidiaries, whose results accrue to GAAP financials but not necessarily GDP. Take for example the S&P 500, an index that skews to market caps of $2.9B and up, which derives 43% of its revenues from abroad. US-listed multinational firms with a disproportionately larger amount of foreign-based sales of goods and services, purchased by foreign-based consumers with intermediate goods supplied from other foreign-based suppliers, will in turn skew today's market-cap/GDP comparison to any pre-1990 levels.

Formula granularities aside, this also highlights critical differences in investment objectives among investors trafficking in the same underlying securities, in this case common equities. Executives managing capital for holding companies, for example that of large property and casualty/life insurers, will have very different objectives relative to those of long-term oriented endowments, pensions, or individuals. This doesn't discredit the utility of a broad metric like market cap in the context of GDP; it just acts as a helpful reminder to keep in context what's being measured.

Another broad proxy of market valuation that removes domicile constraints of GDP and considers all consolidated efforts, both domestic and abroad, is the market's P/E. As chart 2 displays, we currently reside within one standard deviation above the mean forward-P/E (standard deviation being red and green lines, mean being yellow), when observing outcomes since WWII. This current level already has receded 10% from late-2017 ranges, at which time the corporate tax rate cut was announced but not yet implemented. We're also roughly 25% cheaper than high-water marks of 1991 and 1999. Despite being above mean, we see the current mid-/high-teens forward-P/E level as warranted and sustainable, given the strength of the labor market and factors impacting the economic output.

Chart 2: S&P 500 Forward P/E (next 12 mos.)



Source: FactSet, Princeton University Press.
Note: above red line = +1 st. dev., yellow = mean, green = -1 st. dev.

We indeed have seen softening in manufacturing related proxies, and there is no shortage of overhangs that all possess the ability to derail the economic engine: tariff tension escalations, impeachment investigations, geopolitical risks, Federal Reserve policies becoming politicized, 2020 election cycle, etc. As compelling as these all make for headlines and financial news talking points, they have not impaired companies' ability to invest in ventures with return profiles that exceed their cost of capital. We're starting to see affirmations of this across 3Q prints this/last week. Traditional industrial complexes, like Honeywell for example, are noting that order books remain intact with pockets of strength even in regions like China and Russia. Digital transformation continues across every market sector, driving demand for Microsoft's Azure cloud platform. Electronic payments continue to outpace traditional card network growth, as PayPal confirmed recently. Workflow automation continues to proliferate among enterprises, evidenced by ServiceNow's continued efforts to penetrate the Global 2000. Thus far the backdrop of uncertainty has yet to derail many of these initiatives, which we continue to expect to be the case, in turn causing DGO to benefit accordingly.

Raison D'être: Alpha Delivery

Contributors & Detractors

Short-term performance snapshots are always subject to noise, which becomes increasingly difficult to predict with a larger presence of algorithmic participants, but sometimes the noise can be a cacophony when trade agreements and geopolitics increase in uncertainty. The third quarter also endured a large factor swing towards value's favor, specifically a 439 bps advantage unfolding to value relative to growth over the 30-day window ending Sep 27. Due to the number of fundamental inputs and vulnerability to fund flows that impact these types of moves, predicting their arrival contains similar odds to market timing, which tends to revert towards roulette-wheel outcomes over time. This is why we focus on relative outcomes to our stated benchmark, and the inputs that we believe deliver these outcomes, rather than attempt to take a stab at guessing gross price movements. For the third calendar quarter, growth saw a hot start out of the gates for Jul, only to be pared back in Aug and Sep, finishing slightly ahead of its value index counterpart. Due to underperformance from the smaller market caps, exhibited by the Russell Midcap and Russell 2000 (i.e. small cap) indices, the Russell 1000 constituency (growth and value below) lagged that of the S&P 500 for the quarter.

3Q2019 Total Returns:

Russell 1000 Growth Index: +1.49%
S&P 500 Index: +1.70%
Russell 1000 Value Index: +1.36%
Russell Midcap Index: +0.48%
Russell 2000 Index: -2.40%
NASDAQ Composite Index: +0.18%

Against our index, DGO underperformed for 3Q2019, returning -0.10% on a gross basis, with 25 of our 51 positions outperforming the index bogey for the quarter. Below we dissect what led to the underperformance.

DGO Performance as of 9/30/2019

	3Q2019	YTD	1-Year	Since Inception (Annualized)
DGO *(net)*	-0.41%	23.15%	2.09%	13.47%
DGO *(gross)*	-0.10%	24.31%	3.39%	14.90%
Russell 1000 Growth	1.49%	23.30%	3.71%	12.80%
S&P 500 *(reference)*	1.70%	20.55%	4.25%	10.66%

Please see performance disclosures on page 9.

Top Contributors

Ambarella, Inc. [AMBA]: +42.4%

Ambarella tops our list of contributors for 3Q after showing early signs of design win traction in a market ripe for increased semiconductor content over the next decade. Having visual compute as its DNA with an intense focus on power envelop has served the company extremely well in consumer end markets that led to success thus far. As far as automotive use cases, Ambarella has a beachhead via video recording applications addressing geographies where onus is on the driver to prove innocence pertaining to infractions behind the wheel, such as dash cams utilized in Russia and Southeast Asian markets. Thanks to its visual compute software stack and enhancements to its portfolio that it's made via the acquisition of VisLab, Ambarella has been able to deepen its relationship with Tier 1 auto suppliers and OEMs with e-mirrors and 360-degree visibility applications. However, the ideal convergence for all image projection technologies in a vehicle would be to have the lane departure system utilize the same sensor input as the electronic mirror/360-surround view system projected to the driver and ultimately have the autonomous driving system do the same. We believe that AMBA is in an ideal position for both the introduction and the convergence of these workloads over time within the automotive market. This is in addition to future growth opportunities in embedded visual computing architectures in home/professional security, alternative transportation, and robotics applications over time. The nature of these design wins is lumpy and in early stages, which makes AMBA's stock subject to short-term volatility, especially during news flow of Chines OEM blacklists and tariffs. However, the pillars to our thesis continue to strengthen, and we see considerable runway to a company with a sub-$2 billion market cap.

Visteon Corporation [VC]: +40.9%

As we highlighted in our last quarterly, we believed that VC shares were poised to benefit from a relief valve, which very much occurred during the release of 2Q results and thus far following its 3Q update. The entire automotive supplier space has been hammered by declines in global end-unit production, while trade tensions and UAW labor strikes add fuel to the fire. Due to the tight correlation with its peers, VC has struggled to put forth evidence that distinguishes itself from a crowded field of competition. However, we continue to see green shoots in efforts to transition its portfolio towards increasing content per vehicle, while diversifying its customer base across global OEMs, and we believe we're just now seeing fruits of this 3+ year labor come to fruition. As cockpit clusters shed analog components for all-digital displays and consumers' smartphone experiences establish expectations for functionality from their vehicle's infotainment system, Visteon's portfolio is well poised to post growth above and beyond industry vehicle production volumes. Additionally, disjointed legacy system controllers will undoubtedly modernize to achieve power and compute efficiency that will be demanded by level 2-5 autonomous systems, and Visteon has achieved early success in its SmartCore and DriveCore platforms due to functionality and software stacks that enable OEMs to design differentiating functionality. Lastly, VC is well positioned for electric vehicle penetration from a secular perspective, both in systems that support an all-electric infrastructure as well as software-centric platforms that bode well for more models that leverage over-the-air updates. We believe that VC's runway into 2020 will continue to reveal these aspects currently underappreciated by the market.

J.B. Hunt Transport Services, Inc. [JBHT]: +21.3%

We view JBHT in the context of the transports sub-sector of producer durables, which namely is a bet against other truckers, rails, airlines, and UPS (FedEx thematically fits but is not an index constituent). Due to the disruptive tentacles of Amazon, along with the arms race of other retailers attempting to enable shorter delivery windows for their own products, we opt for exposure via those better insulated to AMZN. This includes better insulation from its competitive efforts to bring all aspects of distribution in-house, as well as those levered to enabling competitors to play catch-up. From a longer-term perspective, rail-like aerodynamic efficiency can be achieved by platooning fleets of autonomous trucks, which will dramatically change the cost trade-offs of freight via rails vs truck. Even though we arguably are premature in this opportunity impacting shares, positively or negatively, it's an important impending curve-ball to heed as autonomous driving systems proliferate. In the near term, JBHT's dedicated contract services division is well poised to enable final mile delivery for heavier brick and mortar outlets, evidenced by 28% YoY revenue growth in the segment during 3Q2019.

Top Detractors

Zillow Group, Inc. Class C [Z]: -35.7%

Zillow flipped from top-performer in 2Q2019 to top detractor in 3Q2019, highlighting how polarizing the debate is with a company attempting to reinvent the residential home transaction market. The crux of the debate centers around which argument carries more weight, and last quarter revealed data points that fueled the bear case on the shares. A confluence of factors indeed have formed that pave the way for disruption via friction removal in residential transactions, at least for some segment of the $1.7 trillion US existing home sales market. For Zillow, this translates into having an experienced REIT team with the ability to leverage its captive database of 110 million US homes, one that also attracts the largest pool of home shopping eyeballs in the country. In other words, Zillow possesses a competitive advantage that's ripe to extract pre-demand indicators capable of assisting in targeting home purchases with higher propensities for resale. Since this program is in its first year of deployment, its roll-out creates a tremendous amount of confusion and stock price volatility, as perceptions grow prior to the formation of reality. We look to its Sep quarter earnings call to help illuminate the path towards what Zillow has identified as a $20 billion opportunity to add value around many aspects of deal flow; this includes purchase visibility and timing flexibility to sellers, captive listing referrals to existing premier agents, and ancillary attach opportunities to buyers/sellers related to the transaction (mortgage origination, titling, insurance referrals, etc). Thus far, demand far outweighs supply—Zillow received 69k inquiries in 2Q of which it was able to fulfill 1.5k—but balance sheet intensity is more the concern in a period where investors are rightfully weary of anything resembling large portfolios of residential real estate. With a fresh $1.1 billion of capital raised in its September convertible debt issuance, the company should have the necessary dry powder to be a pioneer in this segment for many quarters to come. Even though we are unlikely to receive a complete overhang lift when Zillow reports in early November, we should gain a better assessment of the company's odds for success that will allow us to recalibrate our model for its long-term opportunity.

Netflix, Inc. [NFLX]: -27.1%

NETFLIX®

We view our Netflix position in the context of the media and publishing sub-sector of consumer discretionary, alongside broadcast and cable outfits like Comcast, Charter, and CBS. From the standpoint of active risk, we prefer net exposure here towards content creation and streaming, where watch-time is increasing, rather than linear broadcast and higher capital intensity of network maintenance, areas facing lower viewership and/or higher capital intensity. The main thesis pillars that led to our initial overweight position in Netflix have strengthened since inception, namely a global trend of increasing broadband subscribers, content creators increasingly opting to develop commercial-free/long-form narratives, mobile carriers packaging over-the-top content with subscriptions, and an increasingly enticing catalog of primary content. In the context of the current 2.4 billion and 2.0 billion active users of Facebook and YouTube, respectively, and nearly 4 billion smartphones in service globally, Netflix's current global paid subscriber base of 158 million has a significant amount of penetration runway remaining. Additionally, as its $13 billion of spend per year increases the pool of original content, we see upside longer-term to the perceived value of its $13/month average subscription. All that being said, names with such long competitive runways often experience short-term dislocations, which is how we're viewing net subscriber trends in 2Q2019 for NFLX. Specifically, Netflix saw a QoQ decline in paid net domestic memberships, its first since 4Q2011, whereas its international segment added 2.8M memberships in 2Q2019. Due to release slate timing and a possible vacuum created by HBO's series finale of Game of Thrones in 2Q, we see this phenomenon as short-lived, as evidenced by its return to positive domestic net adds posted for 3Q2019 on Oct 16. Going forward, we see a content slate becoming increasingly relevant to a global base of prospective subscribers, while addressing geographies whose primary viewing devices are mobile in nature, all of which make Netflix's platform well positioned for an entertainment wallet share that's tilting more towards digital and on-demand services. As such, we view these the pull-back as short lived and continue to like our relative positioning.

Wayfair, Inc. Class A [W]: -23.2%

Wayfair has populated our top contributors/detractors list in four of our last six quarterly reviews, with this appearance splitting the difference between the two categories. Despite the yo-yo track-record over our 16-month strategy duration, Wayfair continues to make progress in evolving into a dominant online property in home goods and furnishings segment. As we've discussed in prior quarterly letters, having a dedicated focus to a market where inventory availability historically is difficult to manage, where quick shipment presents unique challenges due to product size/weight and where intense focus on a consumer spend category will continue to create a competitive moat for Wayfair. In this market segment, transport costs alone can erode up to 20% of the revenue dollar. Nonetheless, consumer expectations for same/next-day delivery impact all online retailers, regardless of product category. Wayfair has been steadily investing to push the envelope in the category: with 17M sq. ft. of warehouse space expected by year-end 2019 and continued expansion of its CastleGate program, along with 40 home delivery terminals across the US and Canada, Wayfair's fulfillment infrastructure enables shorter delivery windows and better shipment timing visibility in a market where incumbents offer frustratingly long and obfuscated shipment availability. Furthermore, Wayfair has been expanding internationally, namely in Europe, which should push its non-US contribution rate higher from its current 25% penetration of total revenue. All that said, whenever a company achieves out-sized growth and reinvests all excess cash generation back into its business, stock price volatility can arise as the market attempts to recalibrate long-term prospects off changes in short-term results. Those are the precise conditions that have caused a pull-back in shares during 2Q, as management noted a Jul month slow-down to mid-30% YoY growth, down from its 2Q growth rate of 42%. None of this translates into changes to Wayfair's opportunity to continue to penetrate the $300B home goods market domestically and another $300B abroad in Europe. Therefore, we remain optimistic about the company's ability to continue to gain market share as barriers to online shopping in the home goods market become reduced on the heels of augmented reality and better fulfillment capabilities.

Important Disclosures

Performance results and comparisons are made on a total-return basis, which include all income from dividends and interest, and realized and unrealized gains or losses. DGO returns are shown both gross and net of fees and are calculated by geometrically linking month-end market values of the strategy's inception cohort. Gross return excludes advisory fees paid to the firm. Net returns include the time-weighted deduction of the firm's maximum wrap fee (which includes both SWS's management fee and trading costs) and assume all cash flows occur at month-end.

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This commentary has been prepared by SWS Partners, LLC ("SWS"), a registered investment adviser in the state of Ohio. If you would like a copy of SWS's disclosure brochure, please visit www.adviserinfo.sec.gov.

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