Needham Funds Third Quarter Call
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SPEAKERS
Kathleen Mumma
John Barr
Chris Retzler

Operator: Welcome to the Needham Funds third quarter call. My name is Sheryl, and I will 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 would now like to turn the call over to your host, Kathleen Mumma. Kathleen, you may begin.

Kathleen Mumma: Thank you, Sheryl. Good afternoon, and thanks to everyone for joining our call. We'll review the Needham Funds third quarter and also our outlook for the remainder of 2017.

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.

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With me today on our call are John Barr and Chris Retzler. John is the Manager of Needham Aggressive Growth Fund. Chris is the Manager of Needham Small Cap Growth Fund. They both 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 it was a good quarter for equities broadly, all three Needham Funds outperformed. Last quarter, I highlighted the high Active Share of the Funds. Active Share is a measure of the difference of the holdings in a portfolio from the holdings in its appropriate passive benchmark. A high Active Share fund has the chance to outperform an index, as long as the stocks are the right stocks. Over the last five years, the Needham Funds had approximately 50% of net assets in their top ten holdings, which makes for high Active Share. Many of our top ten holdings outperformed in the quarter.

The quarter had top performance from some of our semiconductor capital equipment investments, and I'll highlight Entegris (ENTG), MKS Instruments (MKSI), Nova Measuring (NVMI), and FormFactor (FORM), were all contributors. The debate in semiconductor circles revolves around cyclical versus secular growth. Many believe that the semiconductor stocks are poised to suffer, in unison, due to an overbuild in capacity. But

NAND memory requires technology and capacity, as it is replacing disk drives in storage systems. In the future, should even 1% of the automobile industry move to autonomous vehicles, the semiconductor industry will need significant new capacity.

At its investor meeting in September, Applied Materials (AMAT) highlighted [its] view that the semiconductor industry will see steady growth. Nonetheless, there will be days or weeks when the "top is in" argument will rule for these stocks. But I believe in the secular growth thesis, and it certainly helped us this quarter.

We're pleased to have available the Needham Funds institutional share class, which was launched at the beginning of the year. In a new development during the quarter, we removed the short-term redemption fee from the Funds. So, refer to the prospectus and sticker for details.

Turning to the quarter, July was another positive month for the markets and the Funds. The preliminary second quarter GDP came in at 2.6%, above the 1.2% from the first quarter. Core Consumer Price Index showed a 1.7% year-over-year increase, which remains below the Fed's 2% target. Both of these indicate a Goldilocks economy, not too hot and not too cold.

August saw the markets flatten out. The S&P 500 eked out a small gain, and the Russell 2000 was down. The Funds were down and slightly underperformed. I'll highlight that in August, brought terrorism in Barcelona, the violence in Charlottesville, troubles in the North Korean situation, stalled healthcare and tax reform policy and some disappointing earnings. But as horrible as this U.S. social scene is, coupled with the current geopolitical and political challenges, none of it is new. I'll cite a quote from Benjamin Graham in the mid-1970s. He said, "Common stock purchase will prove satisfactory when made at appropriate price levels. It may be objective, but this is far too cursory and superficial a conclusion, but it fails to take into account the new factors and problems that have entered the economic picture in recent years, especially those of inflation, unprecedentedly high interest rates, the energy crisis, the ecology-pollution mess, and even the movement toward less consumption and zero growth." While today's issues are different, but at the time, those others seemed insurmountable. I suspect Professor Graham's words on equities will ring true in the future.

For September, it was a good month for the Funds and the markets. The second quarter GDP estimate was revised higher to 3.1%, which was the strongest growth in over two years. The Federal Reserve left the Fed funds rate unchanged at 1% to 1.25%.

We will 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.

The Needham Growth Fund returned 6.84% [Retail class], and the Institutional Class returned 6.98% in the third quarter, outperforming the S&P 500 which returned 4.48%. For the quarter, FormFactor was the top contributor and returned 35.9%. FormFactor provides wafer probe cards used to test integrated circuits. It reported strong quarter results, including some mobile phone customers pulling in shipments. Revenue from DRAM memory, automotive, and radio frequency customers also grew. FormFactor has strong positions at the leading 10 nanometer semiconductor foundry customers, including Taiwan Semiconductor (TSM), which manufactures the processors for Apple (AAPL) phones.

KVH Industries (KVHI) was the second leading contributor and returned 25.8%. KVH reported solid second quarter results and showed positive adjusted EBITDA. KVH's new Agile Communications plan bundles hardware, airtime, entertainment, and operational content and could account for increasing customer additions in the second half. KVH continued its work on a low-cost fiber optic gyroscope for the autonomous vehicle market, and we believe they could receive about $15 million of tactical navigation orders from international defense customers in the fourth quarter. The company and the [Needham] Funds have been waiting several years for these orders, and I believe their receipt would be positively perceived by the market. In July, Vintage Capital filed a 13-G [with the SEC], disclosing it had acquired about 9% of KVH's outstanding shares. Vintage has made successful investments as an activist in a number of small defense electronics companies, some of which were acquired.

CarMax (KMX) was the third leading contributor and returned 20.2%. They reported a strong second quarter with comparable store sales, increasing 5.3% over last year. CarMax is the nation's leading seller of used cars. With our long-term view, CarMax has opportunity to grow from single digit national market share. They have barriers to entry from their scale. They know the logistics of moving cars. They know more about what cars are worth than anyone else. Consequently, they can offer a fair price to both the car seller and to the car buyer.

The largest detractor was Super Micro Computer (SMCI), which fell 10.3%. Super Micro reported 37% year-over-year revenue growth in the June quarter after strong first quarter growth; however, gross margins were down due to higher memory component costs. This was the second quarter in a row of the cost issues. We believe gross margins could rebound in 2018. They also had higher R&D spending, citing new projects for artificial intelligence and autonomous driving.

In August, Super Micro announced it could not file its 10K by the August 29th deadline. As of today, they have yet to file, and they're incurring additional audit and accounting cost. We believe they will be able to get this accomplished. We don't know when. We've owned Super Micro for over eight years and believe in the company's long-term vision to reach $5 billion of server and network equipment sales, up from the $500 million when we invested.

The Needham Growth Fund added to existing positions in PDF Solutions (PDFS), Super Micro Computer, Nutanix (NTNX), and Agile Therapeutics (AGRX) on price weakness. [The Fund] sold [its] position in Cray Computer (CRAY), and we reduced our position in the long-term holding of Express Scripts (ESRX) - we sold about 40% of our position, and we trimmed about 5% of our positions in top holdings CarMax, Thermo Fisher Scientific (TMO), Becton Dickinson (BDX) on price strength. We also sold about a third of our position in Varian Medical (VAR) on price strength. The fund had trailing 12-month turnover of just 15% and an Active Share of 102.73.

I will now turn to the Needham Aggressive Growth Fund. The Needham Aggressive Growth Fund returned 10.78% [Retail class], and the Institutional Class returned 10.92% in the third quarter, compared to a 5.67% return for the Russell 2000. So it was a great quarter of outperformance.

Entegris was the top contributor and returned 31.4%, now the largest position in the Fund. It has been a long-term compounder for the Fund. Entegris supplies filters and chemicals used in advanced manufacturing, particularly for semiconductors. Over 80% of their revenue is from consumables. They make filters that are used in these manufacturing processes as well. To put it in perspective, semiconductor manufacturing plants require filters capable of capturing one contaminated drop of water in a day's worth of water flowing over Niagara Falls. That's filtering one part in a quadrillion. That's the type of purity that's required for semiconductor manufacturing at the leading edge. Entegris reported strong margins during the quarters, and last week, they announced for the first time that they will be paying a dividend.

KVH was the second-leading contributor, and FormFactor was third. Fourth was MKS Instruments, which returned 40.7%. They provide instruments and subsystems that measure control and power advanced processes, with semiconductor manufacturing being their largest market. MKS is benefiting from the strength of its customers, including Lam Research (LRCS) and Applied Materials, and also from its light and motion segment, which it acquired last year as Newport Communications, [which was] a big holding for the Funds.

The top detractor was Reis Inc. (REIS) which fell 14.5%. Reis licenses information to real estate investors. Subscription revenue grew just 1% in the second quarter. We continue to believe that Reis will return to faster growth in the second half of 2017 and longer term to double digit revenue growth.

We added to top positions GSE Systems (GVP), PDF Solutions, and KVH; and to Aspen Aerogels (ASPN), DIRTT Environmental (DRT.TSE), and Clean Harbors (CLH) on price weaknesses. We exited three companies on M&A: NorSat (NSAT), Exa (EXA), and ARI Network Services (ARIS). I'm sorry to see all three go. We also exited long-term holdings Bottomline Technologies (EPAY), Express Scripts, Financial Engines (FNGN), and Ladder Capital (LADR) and Analogic (ALOG).

Fund had an Active Share of 108.3% versus the Russell 2000 and trailing 12-month turnover of just 18%. 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. We're very excited about what we saw in the third quarter. Although we saw some bumpiness in August, many of our long-term holdings bounced back in the September month and that has continued into October. What this opportunity allowed us to do is deploy a significant amount of our capital and cash basis that we had into some of our high conviction names.

The Needham Small Cap Fund Retail returned 5.9%. The Institutional was 6.05%, while the Russell 2000 was up 5.67%. Year-to-date, the Retail [share class] is up 13.3%, Institutional 13.8%, and the Russell is up 10.9%. So we continue to enjoy some outperformance here, as many of our, again, high conviction names are performing very well.

Also, we have returned to a very concentrated portfolio, with our top ten holdings representing 56.4% of the Fund. I know about 12 months ago, that number was much less. We are now returned back to a more normal level where we have been in the past. The top four holdings in the Fund are Pure Storage (PSTG), PDF Solutions, Invuity (IVTY), and Amber Road. Active Share was 99.6% versus the Russell 2000, and the Fund had a beta of 0.84%.

In the quarter, the top contributors were Pure Storage, Corium (CORI), Invuity, Agile Therapeutics, and FireEye (FEYE). These are some of, still, our core holdings, and we're very excited about their future going into the end of the year and 2018.

The detractors in the quarter, one of which is held across all of the Funds, was Reis, as John noted earlier. Amber Road also detracted, but what we are noticing is that a venture capital group who's been in the name for a significant amount of time has been exiting their position, and that has been weighing on the stock price performance of Amber Road, which we actually see as a great opportunity going forward, once that has concluded.

NeoPhotonics (NPTN), an old name that we have been in in the past, detracted in the quarter, but here in October, has certainly and quickly rebounded and is now a positive contributor to the fund overall. PDF Solutions, again, a long-term holding across all the Funds, where John and I feel is set up very nicely going into 2018 and the end of the year.

Although our cash levels were only at 3.9%, which is normally a lower number, we didn't add any significant new names to the portfolio. As I mentioned, we were able to deploy into some of our high conviction investments. We did exit a few small positions, Independence Contract Drilling (ICD), Lifeway (LWAY), and YuMe (YUME), because of an M&A transaction, we exited before the closure. But for the most part, there was not that much activity in exiting names this quarter.

Overall, as we're here now into October and everyone's back to work and out of the low-volume summer months, which is always great to get out of for a small cap manager, the reflation trade and pro-growth themes continue to drive the market higher, as confidence in increased economic activity remains. There will volatility as this process moves through D.C., but we do think that there'll be great opportunities in small caps with that volatility. We continue to expect lower regulations, tax reform, and tax repatriation. We think that tax repatriation, which is a low-hanging fruit with bipartisan support, should really benefit many small and mid-cap companies, as the larger companies look to redeploy that capital and buy growth that they can't develop in their own R&D labs.

Market volatility has generally remained low as it has supported valuations in multiples year-to-date. We certainly are monitoring the central banks here and globally, but it seems to still remain a very coordinated effort with free capital flowing. The high yield market is also supportive of small-cap companies. It's an indicator that we monitor quite closely, as it's very smart money.

In conclusion, earnings season has just kicked off. It looks to be positive so far, and we certainly look forward to listening to the calls of our portfolio companies and new opportunities to hear of any new, good opportunities to redeploy capital. With that, I can turn over for questions.

Operator: Thank you. We will now begin the question-and-answer session. [Operator instructions.] Our first question comes from Peter Perlegos. Please state your question.

Peter Perlegos: Hi, guys. Thanks for taking my call. I just wanted to know a little bit more about the thought process that went into exiting ESRX. Thank you.

John Barr: Thanks for the question, Peter. With Express Scripts, it has been a long-term holding of the Funds, in the past, they added value to the healthcare system by being an innovator with generics and with mail order distribution. More recently, the environment has gotten more complex, and they found themselves in a dispute with their largest customer, who's just recently announced they were going another direction, which is a detractor. But the new opportunities for Express Scripts come from many of the specialty drugs, which carry very high price tags.

Express Scripts, we just felt that we did not have the visibility to see where Express Scripts was creating value on the pharmacist [side], on the drug company side, and on the payer side. If you read the Anthem, their largest customer's [law]suit, you can see that the business has changed a lot. They're going to generate a lot of cash, and it is valued at a significant discount to the market, but we just felt that the growth was muted, as we look forward, and therefore, there were better places to deploy capital.

Chris Retzler: Yes, I mean we also resized the position of that holding in the Fund, and being that it did not fit the high conviction that we once had and the high conviction that we do have in our top ten holdings, we reduced that and resized it. We will continue to evaluate that position over time, but as John mentioned, certainly the competitive environment has changed. The environment in D.C. has changed, which really kicked off, I would say, last year with Mylan [Pharmaceuticals] with the EpiPen and then the discussion around specialty pharma, and how they were all hit quite sizably, more based on headlines. So, we're happy with where we are, but we'll continue to evaluate opportunistically. Earnings this morning came out on it. Stock is trading nicely today.

Peter Perlegos: Okay, thank you.

Kathleen Mumma: Thanks, Peter.

Operator: [Operator instructions.] Speakers, I do not show any further audio question.

Kathleen Mumma: Okay well, if anyone has any questions that arise or any comments, please contact me, as John and Chris and I will always make time to speak with you. Thank you very much for your time today, and we look forward to working with you for the rest of the quarter. Have a great day.

Operator: Thank you, ladies and gentlemen. This concludes today's conference call. Thank you for participating. You may now disconnect.