Call Title: Needham Funds Fourth Quarter Call
Date: January 25, 2018, 2:00 PM ET

SPEAKERS

Kathleen Mumma
John Barr
Chris Retzler

PRESENTATION

Operator: Welcome to Needham Funds' fourth quarter call. My name is Sylvia and I will be your Operator for today's call. At this time, all participants in a listen-only mode. Later, we'll conduct a question-and-answer session. During the question-and-answer session, if you have a question, please press star, then one on your touchtone phone. 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, Sylvia. Good afternoon and thanks to everyone for joining us today. We'll review on our call the Needham Funds' fourth quarter and also our outlook for 2018. 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. Past performance does not guarantee future results and current performance may be higher or lower than these results. Performance current to the most recent month end may be obtained by calling our transfer agent at 800-625-7071.

Today, we have with us John Barr and Chris Retzler. John manages Aggressive Growth Fund. Chris manages Small Cap Growth Fund. Together they co-manage Needham Growth Fund. I'll turn the call over to John Barr.

John Barr: Our mission at the Needham Funds is to create wealth for long-term investors. It was a good quarter for equities but not for the Needham Funds. The averages were up, but the Funds were down.

The Funds finished the year with good absolute performance, up 8-12%, but underperformed the S&P 500 which returned 22% and the Russell 2000 returning 15%.

Our theme for 2017 was "reward and patience." We were rewarded in many of our long-term semiconductor capital equipment and data storage investments, yet a number of our long-term, more value-oriented small-cap investments suffered as investors didn't recognize some of the progress that was made behind the scenes, and there were a few company stumbles as well. The short positions hurt also.

Our outlook for 2018 is positive, with possible stronger economic growth and value recognition in our small-cap companies that lagged in 2017. We look forward to a year of patience rewarded.

Regarding the investment process, we attended the Needham Growth Conference last week and the team saw about 100 companies, including about 40 holdings and 20 private companies. I also attended investor days for 2U (TWOU) and Coupa Software (COUP), and met with Appian Corp (APPN). All three are new, albeit very small investments for the Funds.

Turning to the quarter, October was another positive month for the markets. The Funds were positive, but underperformed the averages. GDP and inflation indicated an economy that's not too hot and not too cold. The markets continued to be strong in November and the Needham Small Cap Growth Fund had a strong month and outperformed significantly. We learned that GDP grew 3.3% in the third quarter, which was the fastest pace since 2014. We also saw progress on the tax bill, which would be a generational change in favor of an internationally competitive corporate tax structure.

December was a mostly flat month for the averages, but a down month for all three Funds. December did see the passage of the tax bill. However companies in other sectors, such as financials, industrials and consumer, may have a greater short-term benefit than our small companies, which are not yet major taxpayers. The Needham Funds were hurt by a few of our small-cap and short positions.

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.

The Needham Growth Fund institutional class was down 2.4% and the retail class down 2.55% in the fourth quarter, underperforming the S&P which returned 6.64%. For the year, the Needham Growth Fund institutional class returned 8.89% and the retail class 8.32%. As of December 31, the top 10 positions were 52.5% of net assets, continuing the same level of concentration that we've had in the past.

For the quarter, the winners, ViaSat (VSAT) was the top contributor and returned 16.4%; the ViaSat-2 high-throughput satellite was launched and is prepared to go in service on February 1.

Akamai (AKAM) was the second-best contributor and returned 33.5%. On December 15, activist investor Elliott Management announced a stake in Akamai, and Elliott seeks to speak with Akamai about maximizing shareholder value. Three weeks later, Bloomberg reported that Akamai was working with Morgan Stanley on a strategic review. So, in the fourth quarter, our patience on this long-term holding was rewarded.

Becton Dickinson (BDX), another long-term holding, returned 9.6%, was the third leading quarter. They had a good quarter and closed the accretive acquisition of C.R. Bard.

For the fourth quarter, CarMax (KMX) was the leading detractor, as comparable used car sales were up slightly less than [Wall] Street expectations amid much ado about an upcoming peak in used car sales. Note that CarMax has regained half of this decline in the first weeks of January.

KVH Industries (KVHI) was the third top detractor, down 13.4% despite a good earnings report, progress on their strategic plan and an activist becoming their largest investor. All three of those would indicate good stock performance, but KVH is a case of additional patience required, and hopefully value recognized in 2018.

Electronics for Imaging (EFII) was another small cap that detracted during the quarter. The company had disappointing earnings and guidance. However, we are excited about their new Nozomi corrugated box printer for 2018.

The short positions in Ubiquiti Networks (UBNT) and Medallion Financial (MFIN) were detractors. On Medallion, they remain—this is the taxicab medallion lender that is being hurt by Uber and Lyft and ride-sharing; they remain in default on a bank loan that I believe they'll have difficulty repaying. Their bank sued them in 2016 for repayment. They're due in court next week for a summary judgment hearing. This is a basic case of they didn't pay and the bank wants its money back. The stock was up 62.6% in the fourth quarter as the momentum traders seized control.

Needham Growth Fund added to its existing positions in PDF Solutions (PDFS) and Aspen Aerogels (ASPN) on weakness, and to the starter position in Appian Corp. While PDF made progress with its new Design For Inspection and Exensio initiatives, their legacy business lagged in 2017 and we hope for value recognition in 2018.

New positions from IPOs included Altair Engineering (ALTR)and Aquantia (AQ), and I'll point out the Needham Growth Fund continued to reduce its position in Express Scripts (ESRX); the position is down to 10,000 shares as we sold 37,500 in the fourth quarter.

The Fund had trailing 12-month turnover of just 8.5% and Active Share up 107.4% versus the S&P 500.

I'll now turn to the Needham Aggressive Growth Fund, which was down 2.84% in the fourth quarter, and the retail class down 2.98%, compared to a 3.34% return for the Russell. For the year, the Aggressive Growth Fund institutional class returned 9.36% and the retail class 8.73%. As I said, not a bad absolute return. The top 10 positions are 57.6% of net assets, so these 10 positions really matter to us. Akamai was the top contributor during the quarter. Reis (REIS), a small cap, was the second leading contributor and returned 15.7%. We believe new products could return Reis to double-digit growth starting in 2018, which could be positive for the stock. Apple (AAPL), long-term holding, was the third leading contributor; iPhones and services exceeded expectations.

The short positions were top detractors; KVH was the second leading detractor. As far as trading, we added very little in the quarter, added Aquantia and Altair Engineering, the two IPOs; and then the largest additions were to Aspen Aerogels on its weakness and to Appian Corp.

The Fund had an Active Share of 112.7% versus the Russell 2000. Trailing 12-months turnover was 15%.

Looking to 2018, I'm optimistic about the prospects for PDF Solutions, KVH Industries, Reis, GSE Systems (GVP), Electronics for Imaging, and the other small-cap holdings that underperformed in 2017. So, 2018 might and we hope be a year of patience rewarded. I can now turn 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 today. As John mentioned, the fourth quarter of 2017 was a challenging one for all three Funds, but on an annual basis we felt good where we ended.

In the fourth quarter, the Needham [Small Cap Growth Institutional Class] was down 1.1%, the Retail [class] down 1.3%, while the Russell 2000 total return was up 3.34%. For the year, the Institutional class was up 12.5%, the Retail was up 11.9%, and the Russell 2000 was up 14.6%.

Unfortunately, what we saw in the month of December really took away much of the outperformance that we had achieved throughout the year. However, in many cases we think that that's a temporal correction in some of these names, which we can discuss further.

The Fund has returned to its more concentrated historical levels, with its top 10 holdings representing 54% of net assets, with the top holdings being PDF Solutions, Pure Storage (PSTG), Amber Road (AMBR), Super Micro Computer (SMCI), and Invuity (IVTY). Active Share was 100.4% versus the Russell 2000. The Fund had a beta of 0.85.

Two top contributors for the quarter, that were also the two top detractors in the month of December, were Nutanix (NTNX) and NeoPhotonics (NPTN). Other performers for the quarter were Reis, Aspen Aerogels, as we saw recovery in the energy markets, and Air Lease (AL) on the leasing of airplanes, which has been a long-term holding.

Detractors were Invuity, where we've understood that an activist that had entered the name has been losing assets and was in the process of selling out their full position. We look forward to hearing them on their earnings call here shortly to get an update on their fundamentals, which we believe still remain robust.

Another large detractor unfortunately was Agile Therapeutics (AGRX), which had been bought properly last year at very good value levels, and had been increasing in value throughout the year. It unfortunately hit an approval snag in its discussions with the FDA, and in one day we lost a significant portion of those gains. Since that announcement in December, the stock has recovered a little bit, but we expect that if there's a positive result with the FDA, this could be a multiple return to the Fund.

A couple other names that had detracted in the quarter, although we still feel good about, were FireEye, KVH Industries as John mentioned, and heretofore in the new year KVH is hitting new 52-week highs. Corium (CORI) was also impacted, as they're a partner with Agile Therapeutics. Again that name is also at this point hitting 52-week highs.

We didn't add many positions in the quarter, as we sat with our concentrated positions, but we did add two names, one of which John mentioned, Electronics for Imaging, which had a challenging quarter, and we feel is now at good value levels and we added it to the small cap. Another was Ichor Holdings (ICHR), which is a semi-cap equipment name, which is a good comp to our historical holdings in Ultra Clean [Holdings] (UCTT), and we entered the position, and thankfully it's already up almost 50% since its purchase in the fourth quarter.

We did exit a handful of names, some because of valuation, others as we did tax planning at the end of October to try to capture really as much losses as we could. That list of names includes Analogic (ALOG), Approach Resources (AREX), Core Labs (CLB), Express Scripts, Infinera (INFN), Mobile Mini (MINI), Servicesource (SREV) and Under Armour (UAA).

As John mentioned, we attended the 20th Annual [Needham] Growth Conference here in New York in the last few days, where we were able to meet with over a hundred companies across the entire team, a handful of them across the three portfolios. What we took away when meeting with these management companies is that the real world is doing well. The stock market may be at 52-week highs, there may be anxiety, there may be walls of worry; but when you talk to the real job creators in this world, the companies we invest in, their outlook is positive. We believe that their planning will be measured, although there's a new tax plan in place and there's many good things that people can get excited about near term, what we found when speaking with managements is that they're going to be evaluating all these options and will be proceeding with caution over a period of time. But certainly the tailwind is behind them, with an administration that is pro-business.

With the market volatility that continues to remain low, this has helped to support valuations and multiples. We do expect that the Fed will be continuing to raise interest rates; however, the yield curve remains quite flat, and when you compare yields between twos and tens there is a very tight yield curve, which is supportive right now of these multiples.

We also keep a very keen eye to the high yield market, as that's very supportive of small cap stocks. However we will keep an eye on it as an indicator that if there's any sort of volatility or decline in those markets, it could lead weakness to the small cap equity asset class. But currently we feel very comfortable.

One of the other major benefits of this tax reform, which we've talked about since December of '16, is we do expect M&A to continue and quite frankly accelerate. We think that small cap companies and mid cap companies will be beneficiaries of this trend, as large cap companies look to buy growth and repatriate cash back here on shore and look to deploy that in good accretive and strategic reasons.

While the tax reform is here, we think that that will play out over a period of time, and you need to be patient. We also have expectations of continued lower regulations and other high growth opportunities that will support the market.

Earnings season has just begun and it's been positive so far, but we expect earnings to continue to remain constructive, and we will be looking as companies begin to give us better guidance on the impact from the tax reform.

Technology, one of our core areas of investment, continues to remain a bright spot.

Four themes that we continue to see, three of which are in the technology space, the semiconductor capital equipment sector remains strong as technology improvements continue and capacity build-outs lead to greater utilization. Some of the beneficiaries that are across all these Funds are Photronics (PLAB), FormFactor (FORM), and PDF Solutions that John talked about earlier.

Another major area is cybersecurity, I know we've talked about this in the past; but our investment there is in FireEye (FEYE).

We also expect a continuation in the defense modernization and military spend in two of our investments in KVH Industries and Frequency Electronics (FEIM), as well as a broad array of the semiconductor space, continues to drive that forward.

Another area that we did talk about was the energy recovery, and where we see oil now at $65 is certainly giving a tail-wind to companies like Aspen Aerogels as well as many of the other companies that have tangential business into that space, that we saw a down-turn in about four years ago.

With that, I'd like to turn it back over to Kathleen for any questions.

…

Kathleen Mumma: Okay. Well, if any questions do arise, or comments, please contact me, and John and Chris will always make time to speak with you. Thanks for dialing in today and we wish you a great start to 2018.

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