

*The Growth Factor* Commentary by John Barr, [jbarr@needhamco.com](mailto:jbarr@needhamco.com)  
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## *Needham Aggressive Growth Fund Investment Process & Chuck Jaffe's Money Life Podcast*

On March 19, 2021 I appeared on Chuck Jaffe's [Money Life podcast](#). Chuck's mission is to improve financial literacy, and he brings years of experience as a journalist and broadcaster to this daily podcast. It's one of the leading financial podcasts and I recommend it for a listen. We had a great discussion about my investment process, opportunities in today's market and "Quick and Dirty" stock questions from his listeners.



In this issue of *The Growth Factor*, I will describe my 3-part investment process. In a future issue, I will write about opportunities and answer Chuck's Quick and Dirty stock questions.

## *Needham Aggressive Growth Fund's Three-Part Investment Process*

Needham Funds' mission is to create wealth for long-term investors. I do that by investing in companies that I believe may compound returns. The Needham Aggressive Growth Fund (NEAGX/NEAIX) has trailing 12-month turnover of 13% - I look to hold investments in companies for many years.

There are three parts to my investment process:

1. **Discovery of a Hidden Compounder**
2. **Transition Phase**
3. **Quality Compounders - the "hold on" phase**

## *Part 1: Discovery of a Hidden Compounder*

I'm always searching for what I refer to as "**Hidden Compounders.**" I look for:

- Companies with the **potential to grow 5-10 times their current size.**
- **Management teams that think long-term.** I have had success with management teams who were company founders or long-tenured employees who rose to become CEO or, family run businesses.
- **Companies in the midst of an investment phase that obscures the potential for high return on capital.** These companies are investing in new products or services and may be operating at a loss or breakeven. These stocks appear unattractive to quantitative and other investors unable or unwilling to look out a few years. To a factor investor, these stocks appear as "low quality," as they have below-average return on capital.
- A strong balance sheet or hidden assets that provide **downside protection.**
- Most of these Hidden Compounders are **small-cap companies** where market inefficiencies are greatest.

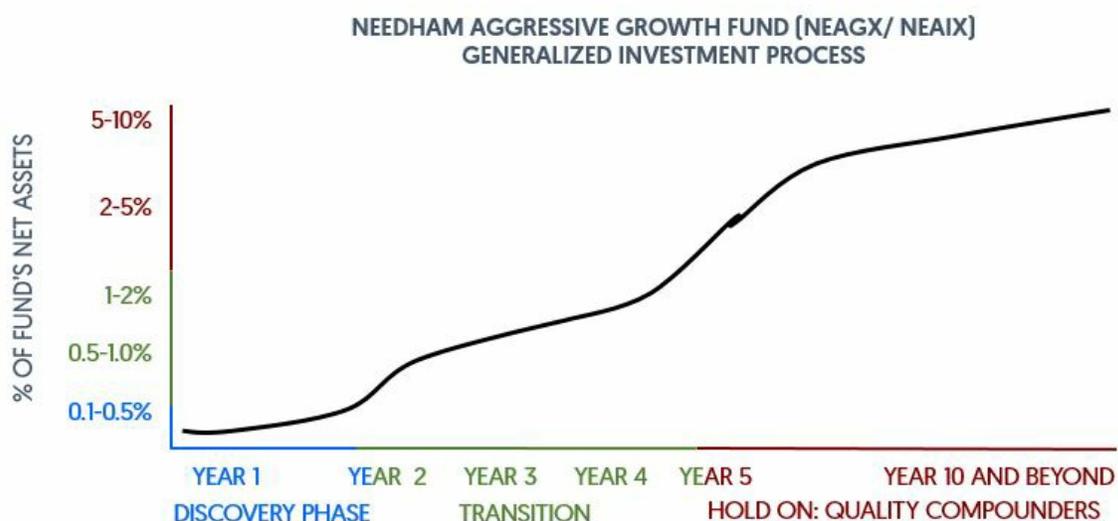
- **Hidden Compounds will rarely have had strong stock price performance;** due to the market's perception of these companies as lackluster performers, they often have flat or declining stock prices.

I add approximately 1-2 new Hidden Compounds to the portfolio per quarter. I look to build these positions over the course of about a year. They generally start as 10-50 basis point positions and will grow to 50-100 basis points through additional purchases and market appreciation in the first 1-2 years.

At December 31, 2020, about 10-15% of Needham Aggressive Growth Fund's net assets were invested in Hidden Compounds. Individually, these holdings rarely affect the Fund's performance in the near-term due to their initial small size. A successful Hidden Compounder will appreciate 20-50% or more in 1-2 years and graduate to the Transition phase. Some Hidden Compounds don't make it and the Fund may take losses on these investments. The real impact from these investments comes from growing into Quality Compounds and returning multiples of our purchase price in the years ahead.

## Part 2: Transition Phase

Companies begin the move to the **Transition Phase** when there are improvements in profitability and revenue. Quantitative investors start to notice these improvements, but these companies are not yet performing close to their margin potential. The Transition phase may last a year or so. With market appreciation and opportunistic purchases these investments may grow to 50-400 basis points of the Fund's net assets. These stocks may appreciate 200-300% or more before graduating to Quality Compounds. At December 31, 2020, about 20% of the Needham Aggressive Growth Fund was invested in companies in the Transition phase.



## Part 3: Quality Compounds - the "Hold On" Phase

The final phase in my investment process is holding on to **Quality Compounds** – the **"hold on" phase**. The hardest part of this phase is to resist the siren song to sell, and instead to hold on! Of course, it is important that my long-term growth thesis remains intact.

Quality Compounds have emerged from their investment periods and are showing revenue growth, profitability and strong returns on capital. Quantitative investors notice them. These stocks may also experience multiple expansion. Their high return on capital gives them a high quality factor; generally, stocks with a high quality factor exhibit outperformance in down markets.

These companies have matured into more predictable cash generators and are able to more safely

use leverage. Leverage improves their return on equity and is also used by these companies to acquire complementary businesses. These companies are often able to improve margin structure and drive revenue growth when they acquire smaller companies; success, leverage and M&A becomes a virtuous cycle. Current Quality Compounders in the Needham Aggressive Growth Fund have appreciated 300% to 3,500% and have been held for 4-15 years. At December 31, 2020, 60% of the Fund was invested in these Quality Compounders, which contributes to the Fund's high quality factors.

Of course, not all investments become Quality Compounders. For those investments that are successful, circumstances can change and the Fund may lose money on investments that were previously successful.

## Summary

I look to create wealth for long-term investors by discovering Hidden Compounders and holding them through their transition to Quality Compounders. I look for companies that may grow to be 5-10x their current size and compound returns at an above-market rate for many years. While the process starts with discovering Hidden Compounders, the hardest part of the process is to hold on and let time work to our advantage. Chuck, thank you for the interview.

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