The Growth Factor - Commentary by John Barr, jbarr@needhamco.com

April 14, 2022 - Vol. 33

Maintaining Conviction During Volatile Markets

Recent global events, including the Russian war on Ukraine, the COVID-19 recovery, and the persistence of inflation, allow investors to reflect and reinforce that daily headlines contributing to market volatility may not correlate with long-term returns. Humankind has a history of moving forward despite significant challenges along the way. Needham Funds prioritize achieving long-term returns rather than reacting to news cycles that may exaggerate market volatility. Below we describe our approach to managing Needham's Aggressive Growth Fund and Growth Fund through volatile markets.

How do Needham Funds approach volatility?

Needham Funds' objective is to generate long-term wealth, not day-to-day returns. We believe the market often focuses on short-term issues, and that alpha can be generated through time arbitrage. The average holding period for the largest ten positions in each fund is about ten years. In this Growth Factor, we outline Needham Growth Fund and Needham Aggressive Growth Fund's approach to investing – buying and holding "Hidden Compounders" with the hope they develop into "Quality Compounders." Of course, not all the Funds' investments succeed and become "Quality Compounders."

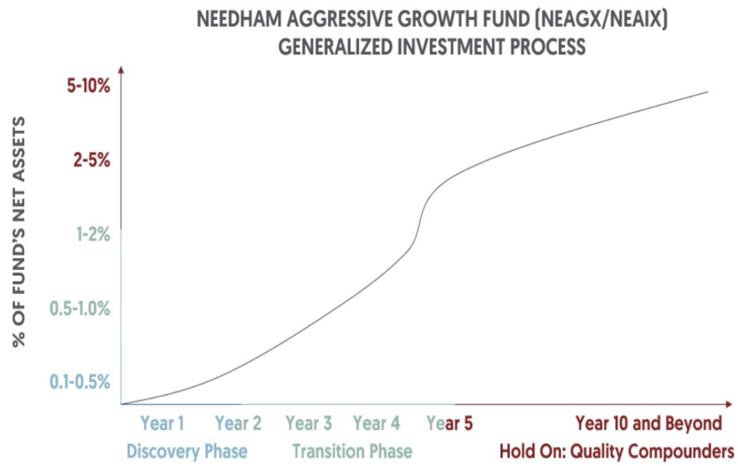
Investment Process

1) Discovery of a "Hidden Compounder"

We define "Hidden Compounders" as companies with the potential to grow 5-10 times their current size. While these companies can be any size, we often find Hidden Compounders in the small-cap universe. We look for management teams that think long-term, and we've had success with companies managed by founders and their families, or managers promoted through the ranks. We also look for companies investing in new products or services that have yet to show returns. Investors looking only at quantitative screens will not find companies making these types of investments. Finally, we look for companies that may provide reduced downside participation. Downside participation may come from a company's legacy business that generates cash but is not growing, from a strong balance sheet, and from an attractive entry price. We call these four characteristics combined a "Hidden Compounder." We may take a year or more to build a position.

2) Transition Phase

The transition begins when a company's financial performance improves. Investors may begin to notice improvements in the company's profitability and revenue. It may take 2-4 years before the company is performing consistently. Our successful investments could see market appreciation during the transition phase. When a company in the transition phase experiences a C-suite shake-up, fails to execute on strategic initiatives or endures other negative impacts, we may consider exiting the position.



3) The "Hold On" Phase: Quality Compounders

As the late Tom Petty said, "The waiting is the hardest part." The final step in our process, the "Hold On Phase," is where patience may be rewarded. It may take five years or more for a company to transition successfully from a Hidden to Quality Compounder. We call these "Quality Compounders," after Morningstar's "Quality Factor," which is based on a company's profitability and financial leverage. At time of purchase, our Hidden Compounders may be operating at break-even and with minimal leverage. As a company's financial results improve, it may generate cash, which could further reduce leverage. Profitability and low leverage result in a high Quality Factor. It may use its larger scale to pursue strategic acquisitions that may temporarily increase leverage. Companies with high Quality Factors may outperform in volatile markets.

By holding on, Quality Compounders may rise to be the largest holdings in the Needham Aggressive Growth Fund and Needham Growth Funds. The top ten holdings of both Funds are generally near 50% of net assets and have an average holding period of approximately ten years. With success, these investments may see a return of 10-20x or more. The challenge is to hold onto "Quality Compounders" and let compounding work for us.

The factors for selling a long-term investment are similar to selling at an earlier stage. We may sell an investment when something goes awry with our view of the product strategy or if management and its vision change. Judging the impact of management changes is hard. We rarely sell because of valuation.

What could go wrong?

Our investment process is not bulletproof; things can go wrong with our investments when they are more minor positions. Our companies may stumble, or we may make a wrong decision. If we purchased with a margin of safety and took time to build a position, we may be able to limit our loss. It is important to remember that past performance does not guarantee future results; our investment process may not protect from market forces. Many of our largest holdings that we consider Quality Compounders declined 20-50% in the first quarter of 2022. In most cases, company performance was as expected. In the first quarter of 2022, the Needham Aggressive Growth Fund (NEAIX/ NEAGX) returned -14.56% / -14.74%; Needham Growth Fund (NEEIX/ NEEGX) -13.94% / -14.04%; and the Russell 2000 Growth Index -12.63%.

Conclusion

As we look to create wealth for long-term investors, our approach is to be patient and look at volatile markets with a broader perspective. By identifying Hidden Compounders and holding them through their transition phase to Quality Compounders, investors may be able to withstand volatile markets to see above-market returns for many years.

Although this Growth Factor is in response to current market volatility, millions of people have been affected by COVID-19 and Russia's invasion and brutal assault on the Ukrainian people. We hope for a world where COVID-19 no longer disrupts lives and there is peace in Ukraine and throughout the world.

About Needham

The Needham Group is an independent, employee-owned firm with consistent leadership for 36 years. Needham has two subsidiaries, Needham & Company and Needham Asset Management. Needham & Company was co-founded by George Needham in 1985 as an investment bank focused on small and midcap companies, with deep sector expertise in technology - namely semiconductors, software and life sciences. Needham & Co offers investment banking, sales, trading and publishes equity research on over 350 public companies in 20 sectors.

Needham Asset Management was founded in 1992 to invest long-term in small and mid-cap companies. Today, Needham manages over $700 million across three 1940 Act mutual funds and 2 hedge fund limited partnerships.

NEEDHAM FUNDS QUICK LINKS:
The Growth Factor
Manager Commentary & Insights
Prospectuses & Fact Sheets

For details regarding the Needham Funds, please contact the Fund's Transfer Agent at 1-800-625-7071.

kmumma@needhamco.com
www.needhamfunds.com
250 Park Avenue, 10th Floor
New York, NY 10177