NeedhamFunds

THE GROWTH FACTOR

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By John Barr, Portfolio Manager, NEAIX/NEAGX and NEEIX/NEEGX

The Importance of Patience

"The stock market is a device for transferring money from the impatient to the patient."

-Widely attributed to Warren Buffett

Throughout my investing career, I've found that patience is the most important virtue for creating long-term wealth. The Needham Aggressive Growth Fund has an average holding period of over eight years, and the Fund has held most of its leading contributors for even longer. Significant drawdowns can come with long holding periods. These same contributing stocks have experienced drawdowns of at least 50% while the Fund owned them.

"Buy low, sell high" is something we've all heard before. In an ideal world, the Fund could have sold high, before those drawdowns began, and bought back at the lows. However, in our view, there are a number of problems with this approach.

1) How do you know it's a high? By selling at what you think is a high, you ignore the prospect that fundamentals could go very right. The Fund's biggest winners have achieved results I never imagined when I first bought. These long-term winners may be responsible for a large share of a portfolio's returns.

2) When do you buy back? I've found that once I sell a stock, it is very unlikely I will buy it back. Whether it's a lack of attention or concern that the fundamentals will deteriorate, it is very hard for me to buy back a stock.

3) Taxes. If you are able to sell high, you've just realized a taxable gain. It may be better to hold and have an unrealized gain if the investment is later successful.

4) Transaction costs. Less trading means lower transaction costs.

I've found that by holding on to positions, even through difficult times, the Fund can compound returns from some of its investments across many years.

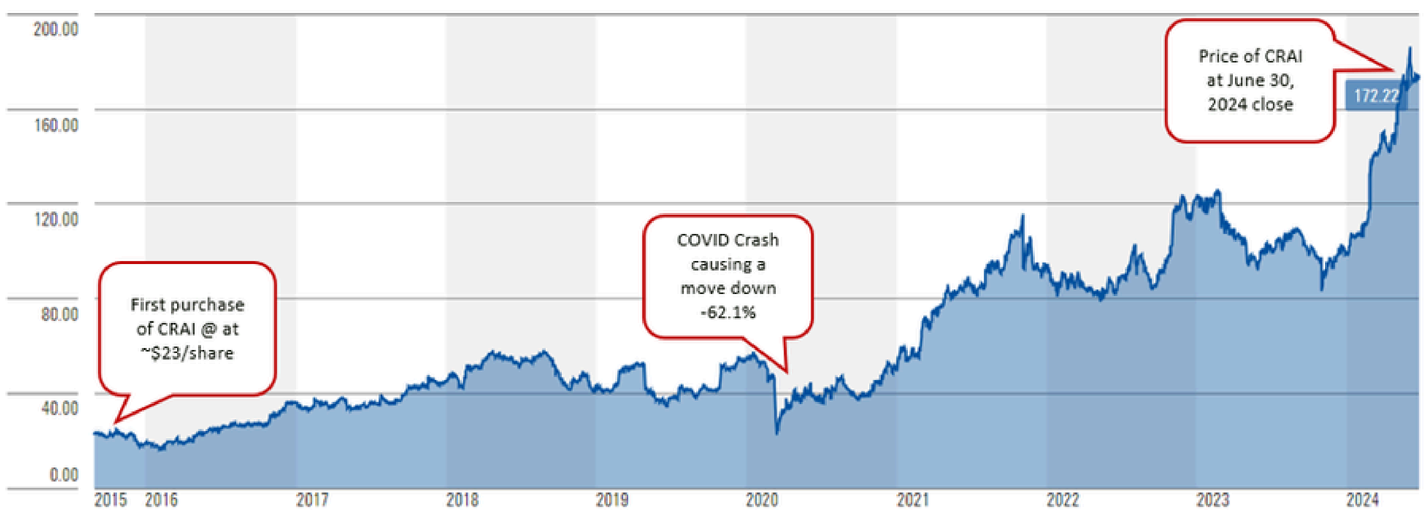
Needham's Approach

During my tenure as the Portfolio Manager of the Needham Aggressive Growth Fund, I have focused on identifying "Hidden Compounders." If you have read our Growth Factor series, you may already be familiar with my investment process: Hidden to Quality Compounders.[1] I look to buy companies with an established business that are investing in a new product or service the market does not yet recognize. I also look for a margin of safety price, regardless of the macro environment, in an effort to reduce downside participation. If the investment thesis quickly proves to be correct, the first purchase price could turn out to be the "low" point. Most investments, however, require us to patiently hold while the stock price experiences new "highs" and "lows" as the market digests the company's progress.

The challenge is to not sell as the stock price moves up or down. During times of volatility or large price movements, our team revisits our thesis and assesses the best course of action. If the price has declined significantly, we may see it as a buying opportunity and add to the position. The primary drivers for a sale could be, but are not limited to, a deviation from the investment thesis, a change in management, or when a position exceeds roughly 10% of net assets. Generally, the Fund does not sell based solely on valuation or price volatility. As long as the investment thesis stays true, we remain confident in maintaining the position and strive for more "highs."

Let's take a look at three examples highlighting different investments and the course of action that we took.

CRA International, Inc. (CRAI)



CRA International, Inc. is a global consulting firm that provides expert testimony and litigation support, strategic advice, and analysis to law firms, corporations, accounting firms, and governments. Its practice areas include Antitrust and Competition Economics, Energy, Financial Economics, Forensic Services, Intellectual Property, Labor and Employment, Life Sciences, and Strategy and Transfer Pricing. CRA benefits from increased regulatory oversight.

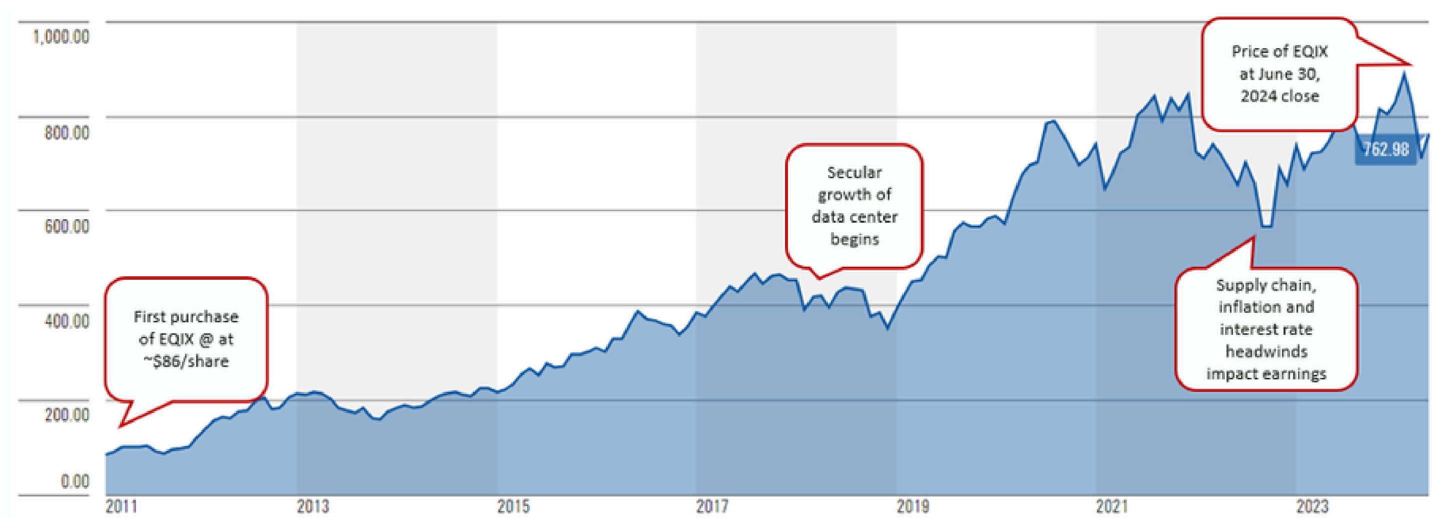
We first purchased CRA in August 2015 for an average price of $23/share. While I thought it was expensive at the time, trading at 15x earnings, the company fit our criteria for a Hidden Compounder. We thought that CEO Paul Maleh and his team might be able to increase operating margins over a few years. Management also regularly bought back stock, shrinking the share count.

We enjoyed consistent performance and a quarterly dividend, resulting in an annualized return of 23.7% for the first five years of ownership. We added to the position in 2019. In the COVID-19 crash of March 2020, CRA's stock price fell from a January high of $56 to a March low of $22, representing a 62% drawdown. CRA underperformed the Russell 2000's 44% drawdown. Panic! What to do?

If we had employed a 20% stop loss strategy, for example, we might have sold CRA in the mid-$40/share and avoided this big sell-off. Sounds good, but we wouldn't have known when to repurchase. Rather than try to time a sale and repurchase, we held, and in the second and third quarters of 2020, we added. As Peter Lynch said, "I've found that when the market's going down and you buy stocks wisely, at some point in the future you will be happy. You won't get there by reading, 'Now is the time to buy.'"[2]

As of June 30, 2024, CRA's stock price was $172/share as it has grown revenue and expanded margins. The Fund's initial purchase had a total return of 649% at June 30, while the stock recovered from its COVID lows by 684%. The stock is also over three times the price that we would have gotten if we had "perfectly timed" an exit in January of 2020.

Equinix, Inc. (EQIX)

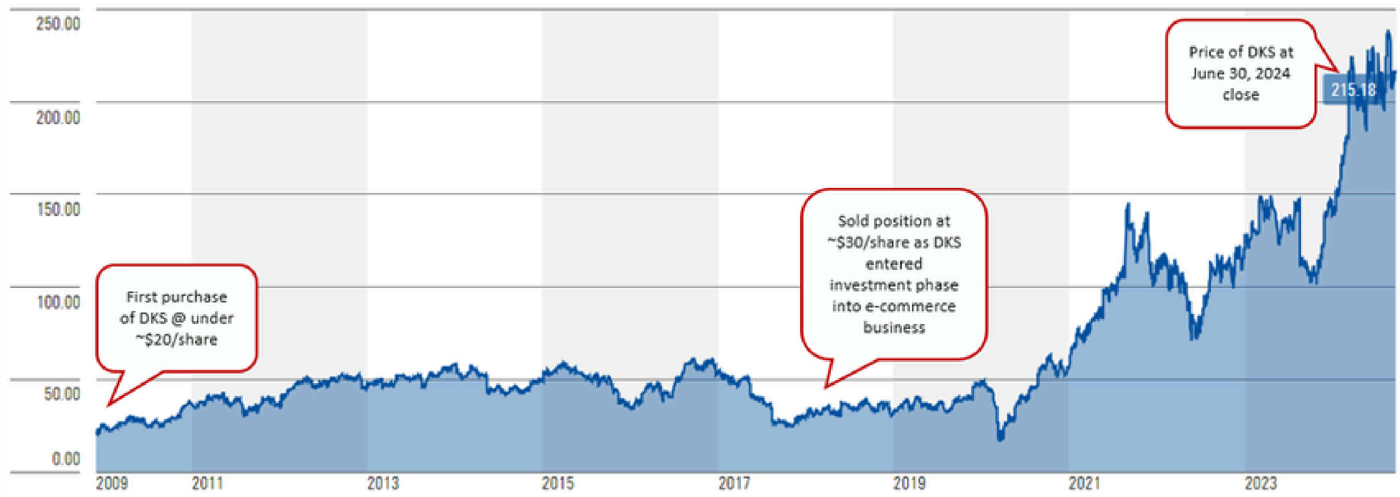


Equinix, Inc. owns and operates data centers around the world, where businesses securely store and run their cloud solutions. At Needham, we have long believed in the secular growth of the data centers. In 2011, the Fund made its first investments in Equinix at an average of $86/share.

The Fund benefitted from Equinix's positive contributions for the first six years in the portfolio, as the demand for data centers grew steadily. In 2017-2018, the data center market transitioned to higher growth. Amazon (AMZN), Microsoft (MSFT), and Google (GOOGL) expanded and, together with enterprises, increased their use of Equinix data centers. This trend was beneficial for Equinix, and its stock hit an all-time high of $885/share in September 2021. From that high, Equinix fell to a low of $494/share in October 2022. The stock suffered due to inflationary costs, supply-chain bottlenecks, and higher interest rates. 2022 was a terrible year for the markets, but Equinix suffered even more.

Since its drawdown, Equinix's stock price recovered to $757/share as of June 30, 2024, up 52%. While it has not fully recovered to its all-time high, we believe in the investment thesis. In fact, we added to our position in 2022 and 2024. Since the Fund's initial purchase, the stock has increased 860%, and the company has paid a dividend since late 2014.

Dick's Sporting Goods, Inc. (DKS)



LLastly, I provide an example where we did not practice patience and the Fund missed out on considerable upside. My predecessor Bernard Lirola bought Dick's Sporting Goods during the financial crisis of 2008 at under $20/share. When I took over the Fund in 2010, I believed that Dick's large store format gave it advantages that would lead to outperformance. The stock reached a high of $60/share in 2016 before falling to a low of $24 in 2017 due to feared competition from Amazon.

At the time, we believed that Dick's new e-commerce strategy would succeed but that it could take a few years to prosper. At the beginning of 2018, we exited the position for $30/share, representing a nice premium over the recent low but a mediocre annual return since the Fund's purchase.

Patience would have been the better decision. In fact, the sporting goods category remained very strong, and Dick's investment in e-commerce has been quite successful. Its omnichannel strategy worked and Dick's has thrived over the last seven years. As of June 30, 2024, Dick's closed at $215/share.

Conclusion

We highlighted three examples of how practicing patience can produce positive results. All three of these companies experienced significant drawdowns during our ownership. Despite the market noise and these drawdowns, our strategy of patience and long-term holding has generated outperformance over the years. However, sometimes we are wrong in our assessment of the fundamentals. The Dick's example shows that for me, it is better to give our investments extra time. By selling we missed significant gains from Dick's, which would have far exceeded the loss we might have avoided even if Dick's had gone to $0.

It is important to ignore most of the market noise and chatter and, instead, spend our time focusing on our portfolio companies' fundamentals. We believe that over time, very few "buy low and sell high" strategies are successful. Our investment philosophy is grounded in the patience to give our investments time to work.

[1] https://www.needhamfunds.com/gf_commentary/maintaining-conviction-during-volatile-markets/
[2] Glenn Coleman. “Peter Lynch: Why He’s Buying Now. Lessons from the Legendary Fund Manager.” Money Magazine, January 2003.

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All three of the Needham Funds have substantial exposure to small and micro capitalized companies. Funds holding smaller capitalized companies are subject to greater price fluctuation than those of larger companies. Also, all the of the Needham Funds are permitted to engage in short sales, options, futures, and leveraged trading strategies. The Funds’ use of short sales, options, futures strategies, and leverage may result in significant capital loss.

Portfolio holdings are subject to change and may be long or short. Needham Aggressive Growth Fund’s ownership as a percentage of net assets in the stated securities as of June 30, 2024: CRAI: 1.66%, EQIX: 0.45%, AMZN: 0.00%, MSFT: 0.00%, GOOGL: 0.00% and DKS: 0.00%.