AMI
ASSET MANAGEMENT

"When one burns one's bridges, what a very nice fire it makes." – Dylan Thomas

Second Quarter 2018

Trade dominated the headlines during Q2 and in many ways dictated the path of stocks throughout the quarter. The implementation of tariffs on major trading partners, while designed to broaden market access for U.S. companies in the long term, has the potential to substantially disrupt economic growth at a time when corporate earnings have generally been solid, with 81% of companies in the S&P reporting a positive earnings surprise.

The Trump administration, making good on 2016 Presidential campaign promises, unveiled tariffs on large trading partners including China and the EU throughout the quarter. These moves were all met with retaliatory tariffs; however, the market largely shrugged this news off and recorded another quarter of gains with the S&P 500 advancing +3.4%. Volatility also returned to relatively subdued levels during Q2 (albeit still higher than 2017) as concerns over the Fed and inflation were put on the back burner. Technology stocks led the market higher but were not immune to trade tensions, while industrial businesses struggled in the face of fears of slowing global economic growth.

Also helping equities throughout the quarter was an easing of certain geopolitical tensions that had presented risks to global stability. A swift reversal by Kim Jong Un, following the Winter Olympics in South Korea, culminated in a summit with President Trump in early June. While North Korea's denuclearization promises have been made and broken in the past, peace on the Korean peninsula and a de-escalation of earlier rhetoric created a favorable backdrop for stocks throughout Q2.

Despite the noise and potential threats from a disruptive trade war, the U.S. economy remains strong. The most recent employment numbers for June showed the economy adding 213K jobs, on top of 244K jobs in May. Due to a higher level of labor force participation, the unemployment rate ticked up to 4.0% but remains historically low. Wage growth, however, remained subdued. In response to solid economic data, the Federal Reserve raised its interest rate target range by another 25 bps to 1.75–2.00% in June. Inflation remains elevated from prior levels but within the Fed's target range, and the Fed seems content to continue raising rates at a moderate pace.

The current bull market, which began in 2009, is already the second longest bull market in history (behind the 1987-2000 bull market). While the recent strong performance has certainly been supported by corporate profitability buoyed by tax cuts, prudence suggests that now is an appropriate time to be holding higher quality companies with strong, sustainable earnings and cash flow. At AMI we continue to invest in companies that we believe will outperform over multiple market cycles and provide downside protection in the event of a weakening economy.

AMI Large Cap Growth Strategy

In Q2, the AMI Large Cap Growth strategy underperformed the Russell 1000 Growth index by 2.24% on a gross basis (2.49% on a net basis). This underperformance was closely split between asset allocation and security selection. Being underweight Technology and Consumer Discretionary (which outperformed the market) and overweight Consumer Staples (which underperformed the market) negatively impacted performance. Security selection was negatively impacted by certain underperforming stock picks in Consumer Discretionary and Producer Durables but was partially offset by outperformers in Healthcare, Consumer Staples and Financials.

As seen in the table below, the top contributors to Q2 performance were Mastercard, Becton Dickinson, Adobe, LabCorp and Apple. The bottom contributors to Q2 performance were Walgreens, Aramark, FedEx, 3M and Starbucks.

Top Contributors in Q2

Company	Avg. Weight	Return	Contribution
Mastercard Inc.	4.34%	12.36%	0.52%
Becton Dickinson & Co	4.43%	10.91%	0.46%
Adobe Systems	3.59%	12.83%	0.44%
Laboratory Corp of America	4.01%	10.99%	0.42%
Apple Inc.	3.76%	10.76%	0.40%

Bottom Contributors in Q2

Company	Avg. Weight	Return	Contribution
Walgreens Boots Alliance	2.24%	-7.77%	-0.18%
Aramark	2.95%	-5.96%	-0.18%
FedEx	3.95%	-5.18%	-0.19%
3M Co	1.94%	-9.77%	-0.21%
Starbucks	2.91%	-15.17%	-0.44%

Top Contributors

Mastercard reported another solid quarter, growing revenue and EPS by 31% and 41%, respectively, driven by continued growth in electronic transactions, a lower tax rate, and share buybacks. We believe this growth trend will continue for some time and remain bullish on Mastercard.

Becton Dickinson reported good quarterly results, driven by good organic revenue growth, combined with margin expansion from the mergers with CR Bard in late 2017 and CareFusion in 2015. Although the cost savings generated by the CareFusion acquisition are waning, synergies from Bard should continue for several years.

Adobe reported a great fiscal Q2 with better-than-expected results on both the top and bottom lines. With shares up over 40% YTD, investors were looking for strong results and the company met the high expectations. Adobe has moved beyond just being a software provider focused on creative professionals and now sits in the heart of the e-commerce ecosystem by combining creative elements with online shopper analytical data. Adobe's Digital Media business (creative software) rose 33% y/y and its Digital Experience segment (marketing services) rose 18% y/y. The company's recent acquisition of Magento should further expand its addressable market and enable Adobe to offer a complete online marketing solution to its customers.

LabCorp reported good Q1 results as the Diagnostics business grew 8%, despite pressure from Medicare reimbursement cuts that went into effect on January 1, 2018. The Drug Development business also performed well, growing 39%, albeit mostly from the acquisition of Chiltern. LabCorp is well positioned to continue to capitalize on the combination of diagnostic testing and drug development outsourcing. In addition, we believe there could be an opportunity to acquire hospital-based labs whose business models are pressured by the recent Medicare cuts.

Apple's fiscal Q2 was mostly in-line with estimates with iPhone sales coming in slightly under consensus expectations. The real highlight in the quarter was the company's services business (Apple Pay, iCloud, Apple Music, etc.) which rose 31% y/y to over $9 billion. The company said it now has 270 million "paid subscribers" using one or more of its services and this has helped reposition the company from a single product, hardware business into a more recurring revenue services company with a massive underlying base of users. Accordingly, Apple's P/E multiple has expanded to account for the greater visibility and stability that comes with being a more recurring revenue business.

Bottom Contributors

Walgreens' fiscal third quarter earnings were generally positive; however, these results were overshadowed by the long-speculated entrance of Amazon into the pharmacy business through the acquisition of online pharmacy PillPack. While Amazon is no doubt an imposing competitor, Walgreens' scale, independence and existing healthcare partnerships have been too severely discounted, in our view. We believe Walgreens will not only be able to effectively compete with Amazon but also grow earnings double digits over the next few years and view the stock as an attractive opportunity at its current valuation.

Aramark reported solid fiscal Q2 earnings highlighted by strong organic revenue growth and margin expansion. However, the stock fell in sympathy with its largest competitor Compass, after reporting poor performance in its North American business. In addition, reports of weak baseball attendance also hurt the stock, as Aramark provides foodservice operations for MLB teams, (~5% of total revenue). Given Aramark's highly diversified business, we view weakness in baseball attendance as unlikely to significantly impact results. We continue to like the company as a broad-based shift toward foodservice outsourcing should drive organic growth and margin expansion over time.

FedEx reported good fiscal fourth quarter results in June, highlighted by strong growth across all three operating businesses: Express, Ground, and Freight. Growth was driven by both gains in volume and pricing, while expense leverage led to margin expansion. Despite the strong results, the stock declined following management's guidance of a temporary increase in capital expenditures in fiscal 2020 and 2021. As a part of its ongoing fleet modernization program, the company is accelerating the purchase of new aircraft to take advantage of the new tax law. We continue to like FedEx due to exposure to quickly growing e-commerce and the expected benefits from the full integration of the TNT Express acquisition from 2016.

3M reported disappointing Q1 results with organic growth falling below the full-year target range. Additionally, management lowered the top-end of its full year organic growth and EPS guidance. Top-line growth was good across all geographies, but certain product categories drove the downside and commodity cost inflation was a headwind to EPS growth. Pricing was strong and offset most of the inflation, but it was not enough to drive meaningful margin expansion. While the guidance reduction is disappointing, it likely sets the stage for a smooth CEO transition at the start of the second half of the year.

Starbucks negatively pre-reported fiscal Q3, outlining that comparable store sales would only grow 1.0%, as opposed to the 3.0% expectations, and lowered earnings guidance for the year. The company attributed the slowdown to delays in advertising the new summer menu following the incident at a Philadelphia store in April, as well as a disruption in China caused by a government-imposed change to delivery services. Despite the stock's recent underperformance, we view these issues as temporary. Starbucks still has a tremendous expansion opportunity in China, and initiatives being rolled out in North America to improve afternoon traffic should stabilize sales and drive the stock higher over the near term.

Portfolio Additions and Deletions

In Q2 we added Microsoft and sold Kimberly-Clark

Enterprise software firm Microsoft has long been a source of stable revenue with its Windows operating system and MS Office applications. In recent quarters, growth has accelerated and has become more recurring driven by a shift to subscription-based applications such as Office 365 and its infrastructure services business, Azure. Microsoft's strong, recent financial results are evidence that it is capturing a higher level of global IT spending and as Azure and Office 365 become an increasing percentage of the product mix, margins should continue to expand over the next several years. Microsoft has a diversified revenue base (enterprise software, hardware, cloud, gaming) and, under new leadership, should continue to innovate and find additional areas of growth.

Kimberly-Clark's business has come under increasing pressure, with headwinds from lower birth rates in developed countries and intense competition in China, Kimberly-Clark's largest market opportunity. In addition, margins are being squeezed by steep increases in oil and eucalyptus pulp, the company's two largest inputs, with an inability to pass along these costs to consumers. Given the lack of any near term positive catalysts, we saw better opportunities elsewhere.

AMI Small Cap Growth Strategy

The AMI Small Cap Growth strategy underperformed the Russell 2000 Growth index in Q2 by 3.37% on a gross basis (3.69% on a net basis). The underperformance was driven by security selection. Underperforming stock picks in Healthcare, Consumer Staples and Energy were partially offset by outperforming picks in Financials. Asset allocation had a positive contribution to performance, as a result of being overweight Consumer Staples (which outperformed the market) and underweight Materials (which underperformed the market).

As seen in the table below, the top contributors to Q2 performance were Syneos Health, Ligand Pharmaceuticals, Financial Engines, Performance Food Group and Carbonite. The bottom contributors to Q2 performance were Callon Petroleum, LogMeIn, Surgery Partners, American Renal Associates and Anika Therapeutics.

Top Contributors in Q2

Company	Avg. Weight	Return	Contribution
Syneos Health	3.66%	32.11%	1.03%
Ligand Pharmaceuticals	4.02%	25.44%	0.94%
Financial Engines	2.37%	28.14%	0.80%
Performance Food Group	3.48%	22.95%	0.72%
Carbonite	3.25%	21.18%	0.67%

Bottom Contributors in Q2

Company	Avg. Weight	Return	Contribution
Callon Petroleum	1.58%	-18.88%	-0.32%
LogMeIn Inc	3.12%	-10.41%	-0.33%
Surgery Partners	3.10%	-13.11%	-0.37%
American Renal Associates	2.29%	-16.34%	-0.48%
Anika Therapeutics	2.96%	-35.64%	-1.24%

Top Contributors

Following weakness in Q1, Syneos Health's stock price rallied in Q2 due to earnings that beat expectations, solid backlog growth, and good 2018 guidance. Although the stock has been volatile due to weakness at inVentiv, which added post-approval drug consulting services following the 2017 merger, the combination of the two companies appears to be beneficial. Management highlighted that it is winning new business based on this broader range of services and additional capabilities.

Ligand Pharmaceuticals reported another solid quarter due to continued growth in its two largest royalty generating drugs, Promacta and Kyprolis, up 47% and 17%, respectively. Also boosting the stock was continued pipeline development, namely Sage Therapeutics' filing for FDA approval for a postpartum depression treatment and Retrophin starting a phase 3 trial for a kidney disease treatment. Both could be significant growth drivers in 2019 and beyond.

Financial Engines stock rose significantly in late April after the company accepted a buyout offer from Hellman & Friedman for a 32% premium.

After a challenging start to the year, Performance Food Group reported better-than-expected first quarter results despite headwinds from poor weather throughout the quarter. Strong volume growth from independent restaurants and improved margins despite food and freight inflation all helped ease concerns that led to the weak performance in the first quarter. Comments from the CEO that the beginning of May was on track to set records for volume growth sparked a rally that continued through the balance of the quarter.

Carbonite's Q1 was strong as the company bested estimates, helped by the acquisition of Mozy. Subscription business bookings growth accelerated to 18% y/y and business bookings are now 68% of the total, as company continues its shift to business from consumer. Margins also expanded to 14.7% from 5.2%, and the company is on track to hit its near-term target of 20%. We continue to like the company's prospects, especially with the new rollout of a disaster recovery as a service product which should further boost growth.

Bottom Contributors

Callon Petroleum reported strong Q1 results that were in line with expectations. However, in May the company announced a $570 million acquisition which is to be partially funded with a 22 million share offering. While the acquisition appears attractive due to the complimentary nature of the acquired acreage, the stock declined following the announcement of the relatively large equity offering. Despite the impact of the stock offering, we continue to like Callon due to its strong acreage position, production growth profile and the attractive addition of the Cimarex acquisition.

LogMeIn produced better-than expected results in Q1. Shares sold off as the company said its recent acquisition of Jive Communications would be mildly dilutive in 2018, leading to slightly lowered guidance. However, the company's core business guidance (ex-Jive) was unchanged. We believe that the strength of the core businesses and its decision to pursue opportunities in the large unified communications market with the acquisition of Jive will ultimately be rewarded as the overall growth of the company begins to reaccelerate.

Surgery Partners was the top contributor in Q1 but a mixed earnings report pressured the stock in Q2. As Surgery Partners integrates its recent sizable acquisition of surgery center operator National Surgical Healthcare, it is culling low margin procedures. Combined with bad weather and rampant flu, this pressured revenue in Q1. Nevertheless, we are encouraged by a new management team which is focused on improving profitability, adding new surgery centers, and exiting unprofitable business lines. Lastly, we see a multi-year tailwind behind the use of surgery centers as they are a lower cost alternative to hospitals, benefitting patients and payers.

American Renal was a strong performer in Q1, rising 8.3%, but late in the quarter the dialysis provider announced a secondary offering of 5 million shares by its largest private equity owner. While this was not a surprise, the market was not able to absorb a share sale of that size and the stock dropped substantially. The selloff carried into Q2, despite a solid Q1 earnings report. Going forward, management believes it has a better strategy to accommodate additional share sales.

Anika Therapeutics stock fell after reporting weaker than expected Q1 earnings as pricing pressure for its legacy knee osteoarthritis treatment was higher than forecasted. Then later in the quarter, the company announced disappointing trial results for its next generation knee treatment Cingal which is a combination of a steroid and Anika's current osteoarthritis product. This product was viewed as major growth driver in 2020 and beyond. Although Cingal worked as expected, it did not show a substantial benefit over steroids alone at 6 months. This was a surprise given that steroids are used as short acting treatment and typically wear off after a few weeks. Anika remains committed to this product, especially since it is successfully selling Cingal outside the U.S., and it will announce the 9-month data shortly. We believe the 9-month data will show a benefit, which could clear the approval path and thus we remain bullish.

Portfolio Additions and Deletions

In Q2 we bought Green Dot; we sold Abaxis and Financial Engines as both companies were acquired.

Green Dot is provider of pre-paid credit cards to the under-banked community, including credit challenged individuals or others who prefer not to have a traditional checking account. Green Dot also has a banking-as-a-service (BaaS) offering, which is essentially a wholesale back end banking function for digital banking apps (i.e. Apple Pay). We see growth from market share gains in the under-banked segment through expanded reseller relationships as well as overall growth in digital banking apps. Margins should also expand with revenue growth.

AMI SMID Cap Growth Strategy

In Q2, the AMI SMID Cap Growth strategy underperformed the Russell 2500 Growth index by 1.35% on a gross basis (1.62% on a net basis). The underperformance was driven by underperforming stocks in Technology and Healthcare, partially offset by outperforming stocks in Financials. Asset allocation positively impacted performance as a result of being overweight Consumer Staples and Healthcare (which outperformed the market) and underweight materials (which underperformed the market).

As seen in the table below, the top contributors to Q2 performance were Syneos Health, Ligand Pharmaceuticals, Financial Engines, Performance Food Group and ServiceMaster. The bottom contributors to Q2 performance were Green Dot, Aramark, LogMeIn, American Renal Associates and Anika Therapeutics.

Top Contributors in Q2

Company	Avg. Weight	Return	Contribution
Syneos Health	3.69%	32.11%	1.03%
Ligand Pharmaceuticals	4.02%	25.44%	0.94%
Financial Engines	2.36%	28.14%	0.80%
Performance Food Group	3.69%	22.95%	0.70%
ServiceMaster	3.61%	16.95%	0.58%

Bottom Contributors in Q2

Company	Avg. Weight	Return	Contribution
ASGN Inc.	3.20%	-4.51%	-0.14%
Aramark	3.00%	-5.96%	-0.19%
LogMeIn Inc.	3.31%	-10.41%	-0.36%
American Renal Associates	1.73%	-16.34%	-0.36%
Anika Therapeutics	2.85%	-35.64%	-1.19%

Top Contributors

Following weakness in Q1, Syneos Health's stock price rallied in Q2 due to earnings that beat expectations, solid backlog growth, and good 2018 guidance. Although the stock has been volatile due to weakness at inVentiv, which added post-approval drug consulting services following the 2017 merger, the combination of the two companies appears to be beneficial. Management highlighted that it is winning new business based on this broader range of services and additional capabilities.

Ligand Pharmaceuticals reported another solid quarter due to continued growth in its two largest royalty generating drugs, Promacta and Kyprolis, up 47% and 17%, respectively. Also boosting the stock was continued pipeline development, namely Sage Therapeutics' filing for FDA approval for a postpartum depression treatment and Retrophin starting a phase 3 trial for a kidney disease treatment. Both could be significant growth drivers in 2019 and beyond.

Financial Engines stock rose significantly in late April after the company accepted a buyout offer from Hellman & Friedman for a 32% premium.
After a challenging start to the year, Performance Food Group reported better-than-expected first quarter results despite headwinds from poor weather throughout the quarter. Strong volume growth from independent restaurants and improved margins despite food and freight inflation all helped ease concerns that led to the weak performance in the first quarter. Comments from the CEO that the beginning of May was on track to set records for volume growth sparked a rally that continued through the balance of the quarter.

ServiceMaster reported solid Q1 results, as organic growth in the company's Terminix segment was better-than-expected despite weather headwinds. Margins also expanded significantly in this segment, showing that investments in service and technology were paying off with improved customer retention. American Home Shield continues to grow nicely as consumers recognize the benefits of home warranties, and the Franchise Services segment benefited from disaster related cleanup business throughout the quarter. ServiceMaster is planning to spinoff the American Home Shield business in Q3, a move we view positively that should help drive further outperformance.

Bottom Contributors

ASGN reported strong Q1 results highlighted by revenue growth of 9.4% in assignment (temp) revenue and a 9.0% increase in permanent placement revenue. Despite the good results, the midpoint of Q2 EPS guidance was slightly below estimates due to timing in the newly acquired ECS business. We continue to like ASGN which is benefitting from accelerated growth in its key verticals and expanded relationships among all customer types. Apex, the company's largest segment primarily focused on temporary IT staffing, continues to perform well across all businesses and verticals.

Aramark reported solid fiscal Q2 earnings highlighted by strong organic revenue growth and margin expansion. However, the stock fell in sympathy with its largest competitor Compass, after reporting poor performance in its North American business. In addition, reports of weak baseball attendance also hurt the stock, as Aramark provides foodservice operations for MLB teams, (~5% of total revenue). Given Aramark's highly diversified business, we view weakness in baseball attendance as unlikely to significantly impact results. We continue to like the company as a broad-based shift toward foodservice outsourcing should drive organic growth and margin expansion over time.

LogMeIn produced better-than expected results in Q1. Shares sold off as the company said its recent acquisition of Jive Communications would be mildly dilutive in 2018, leading to slightly lowered guidance. However, the company's core business guidance (ex-Jive) was unchanged. We believe that the strength of the core businesses and its decision to pursue opportunities in the large unified communications market with the acquisition of Jive will ultimately be rewarded as the overall growth of the company begins to reaccelerate.

American Renal was a strong performer in Q1, rising 8.3%, but late in the quarter the dialysis provider announced a secondary offering of 5 million shares by its largest private equity owner. While this was not a surprise, the market was not able to absorb a share sale of that size and the stock dropped substantially. The selloff carried into Q2, despite a solid Q1 earnings report. Going forward, management believes it has a better strategy to accommodate additional share sales.

Anika Therapeutics stock fell after reporting weaker than expected Q1 earnings as pricing pressure for its legacy knee osteoarthritis treatment was higher than forecasted. Then later in the quarter, the company announced disappointing trial results for its next generation knee treatment Cingal which is a combination of a steroid and Anika's current osteoarthritis product. This product was viewed as major growth driver in 2020 and beyond. Although Cingal worked as expected, it did not show a substantial benefit over steroids alone at 6 months. This was a surprise given that steroids are used as short acting treatment and typically wear off after a few weeks. Anika remains committed to this product, especially since it is successfully selling Cingal outside the U.S., and it will announce the 9-month data shortly. We believe the 9-month data will show a benefit, which could clear the approval path and thus we remain bullish.

Portfolio Additions and Deletions

In Q2 we bought Green Dot; we sold Financial Engines as the company was acquired.

Green Dot is provider of pre-paid credit cards to the under-banked community, including credit challenged individuals or others who prefer not to have a traditional checking account. Green Dot also has a banking-as-a-service (BaaS) offering, which is essentially a wholesale back end banking function for digital banking apps (i.e. Apple Pay). We see growth from market share gains in the under-banked segment through expanded reseller relationships as well as overall growth in digital banking apps. Margins should also expand with revenue growth.

Sincerely,

Your AMI Investment Management Team

If at any time your current financial situation, investment needs or objectives change, please notify your portfolio manager promptly. Enclosed is the latest copy of our ADV Part 2 and Proxy Voting Policies and Procedures. You may call or write us to obtain the latest copy of our Privacy Notice. All attribution data is courtesy of Bloomberg.

The information contained herein reflects the opinions and projections of AMI Asset Management Corporation (AMI) as of the date of publication, which are subject to change without notice at any time subsequent to the date of issue. AMI does not represent that any opinion or projection will be realized. All information provided is for informational purposes only and does not constitute an offer to buy or sell or a solicitation of an offer to buy or sell any security or to participate in any trading strategy. While the information presented herein is believed to be reliable, no representation or warranty is made concerning the accuracy of any data presented. The information in this material may contain projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved and may be significantly different than that shown here.

Past performance is not indicative of future returns. Composite returns are presented gross and net of management fees and include the reinvestment of all income. Gross returns are presented before management fees but after all trading expenses. Net returns for AMI's equity strategies are calculated by deducting the highest annual fee of any account included in the composite of 1.0% (Large Cap Growth Strategy) or 1.5% (Small Cap Growth Strategy) from the quarterly gross return. Please note that the annual fees for institutional accounts are lower than the 1.0% and 1.5% deducted from the gross returns (higher net returns), while certain retail accounts are subject to our minimum annual management fee requirement and therefore have higher fees (lower net returns). Therefore, individual account performance will vary. Net returns for AMI's fixed income strategies are calculated by deducting the highest annual fee of any account included in the composite of 0.60% (Core Taxable), 0.50% (Municipal), or 1.0% (High Yield) from the quarterly gross return. Additional information about AMI's management fees is included in its Form ADV Part 2. Index performance is provided as a point of reference only and does not imply that a Strategy will achieve returns, volatility, or other results similar to the index. The total returns for the index do not reflect the deduction of any fees or expenses which would reduce returns.