US Equity Opportunities

NICHOLAS INVESTMENT PARTNERS

Key Takeaways

- US equities posted solid returns in Q3, led by large caps as a rotation to more defensive positioning ensued during September. The quarter was characterized by rising interest rates and higher volatility due to escalating trade tensions. The S&P 500 rose 7.71% while the Russell Midcap Growth added 7.57% and the Russell 2000 Growth gained 5.52%.
- Security selection was the key driver of US Equity Opportunities absolute returns, as strong company fundamentals were rewarded.
- Innovation-driven companies in biotech and healthcare equipment were particularly strong performers for the portfolio.

Performance as of September 30, 2018

COMPOSITE PERFORMANCE (%)	US EQUITY OPPORTUNITIES (GROSS)	US EQUITY OPPORTUNITIES (NET)	S&P 500 INDEX
MTD	-1.53	-1.60	0.57
QTD	5.68	5.46	7.71
YTD	17.62	16.87	10.56
1 YEAR	27.70	26.61	17.91
3 YEAR	18.83	17.83	17.29
ITD*	13.53	12.57	12.05

**Composite inception date: 7/1/2014. Returns over one year are annualized. Performance for individual accounts may vary. See performance disclosure for additional information. Past performance is no guarantee of future results.*

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MARKETS DYNAMICS

It was a strong quarter for equities. Stocks scaled a wall of worry in Q3, driven by a mix of renewed synchronized global economic growth, robust Q2 earnings growth and strong Q3 forecasts. Companies found innovative ways to compete and excel.

- The S&P 500 Total Return Index rose 7.7%—its best quarterly performance since Q4 2013.
- Stocks were strong in most regions worldwide, with only emerging markets generating a negative return.
- All US cap sizes posted gains and large caps outpaced mid and small caps.
- Growth significantly outperformed value in all cap sizes.

LOOKING AHEAD

Equities are attractive—but not without risk. While we see further upside driven by company fundamentals, the US economic expansion and upward revisions of earnings and revenue estimates, we're also aware that the expansion cycle is in its later stages—meaning that growth and valuations are more vulnerable to changing investor sentiment or potential external shocks.

As we write in early October, stocks have already taken a hit from jitters about rising yields across the curve, China and the potential for a US-China trade war to hamper US earnings growth. We wouldn't be surprised by additional choppiness in Q4 (particularly in the runup to and aftermath of the November US midterm elections), but expect markets to weather the storm and enter 2019 with fundamentals in good shape given the ongoing strength in secular growth.

WHERE WE STAND NOW

Emphasis on innovation. With rising volatility putting a premium on effective stock selection, we continue to focus on innovation-driven companies.

Growth style to remain strong. The factors we've cited—innovation, the supportive economic environment, positive earnings and revenue estimates, particularly in smaller cap—should keep growth stocks strong heading into 2019. If growth slows due to an external shock, investors would likely prize growing companies with high earnings transparency.

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PERFORMANCE ATTRIBUTION

US Equity Opportunities closed Q3 in positive territory, marking the 10th consecutive quarter of positive gains and extending its lead over the broader US equity market year-to-date. Positive contribution to absolute returns was broad-based across sector groups, with the exception of consumer discretionary. Strength in healthcare, technology and industrial positions lifted performance the most in Q3, particularly med tech, software, and road and rail positions. Within consumer discretionary holdings, household durable and auto component positions pulled back modestly. Additionally, positions with market capitalizations greater than $30 billion were the most additive to performance while smaller capitalization stocks lagged, mirroring market sentiment during the quarter.

The five largest contributors to absolute returns included Viking Therapeutics (clinical-stage therapies for heart and liver diseases as well as bone/hip fractures), Teladoc Health (remote and mobile tele-healthcare services), Illumina (gene sequencing, genotyping and gene expression services), Everbridge (SaaS-based emergency alert systems) and CSX Corp. (rail freight services). Shares of Viking Therapeutics rallied on the release of phase II data supporting strong efficacy and tolerability profile for its VK2809 treatment to significantly reduce liver fat in patients with hypercholesteralmia (fatty liver disease). Teladoc continued to benefit from strong revenue growth supported by higher membership and utilization trends and reported better-than-expected revenue growth in Q2. Shares of Everbridge rose on stronger-than-expected Q2 results and future growth catalysts, including potential for larger market share gains in federal, state and local markets as well as higher education channel; improved sales productivity and scale with new initiatives. Ilumina and CSX also beat Q2 consensus estimates.

The five largest detractors from absolute returns were WANdisco (cloud-based and on-premises data management solutions), OptiNose (drug treatment for chronic sinusitis), Facebook (social media), SunOpta (natural and organic food products) and CRISPR Therapeutics (cancer and blood disorder therapies). Shares of WANdisco pulled back on broader industry multiple compression in September. We believe the company is poised to benefit from structural growth trends in cloud migration, acceleration of deal flow and recurring subscription revenues as well as entry into blockchain technology. OptiNose delivered on their first post-approval sales report for their newly approved chronic sinusitis drug, but the whisper number was much higher. Our due diligence review confirms prescriptions are tracking well and we continue to hold the position. SunOpta pulled back on mixed Q2 results and margin pressures from weaker-than-expected fruit segment and currency exchange impact. We sold the position to invest in an investment candidate with stronger growth catalysts. Facebook and CRISPR Therapeutics were also sold from the portfolio as earnings and revenue visibility clouded.

Contribution to Portfolio Absolute Return – 3Q 2018

BY SECTOR (%)	
Consumer Discretionary	-0.44
Consumer Staples	0.17
Energy	0.12
Financials	0.49
Health Care	2.63
Industrials	0.85
Information Technology	1.65
Materials	0.05
Real Estate	0.17
Telecommunication Services	0.00
Utilities	0.00
Other	0.01

BY MARKET CAP (%)	
>$30B	2.17
$15B–$30B	0.11
$7.5B–$15B	0.86
$4.5B–$7.5B	0.82
$1.5B–$4.5B	1.19
$750M–$1.5B	0.68
$400M–$750M	-0.35
<$400M	0.20
Other	0.01

BY AVERAGE PORFOLIO WEIGHT (%)	
>3%	0.82
2-3%	2.48
1-2%	2.50
<1%	-0.11
Other	0.01

Source: FactSet, Nicholas Investment Partners. Based on a representative portfolio. Specific securities identified do not represent all securities purchased, sold or recommended to advisory clients. It should not be assumed investments in these securities were or will be profitable. Past performance is no guarantee of future results.

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POSITIONING

Near-term we expect increased volatility ahead of upcoming key industry conferences and a choppier trading environment as investors may be quick to take profits amid broader macro concerns (i.e. rising rates, bifurcation of global growth, global trade wars). As the focus shifts back to earnings, we believe the fundamental backdrop for innovation-driven subsectors remains positive with expectations of continued sales growth strength longer term.

As of September 30, 2018, US Equity Opportunities remains fully invested with 0.03% cash, reflecting a positive outlook on the fundamental strength in the underlying stock-specific holdings and long-term industry trends. The portfolio is positioned with a tilt toward small-to-mid cap companies. Nearly 67% of the portfolio is invested in companies with market capitalizations below $30 billion, with ~41% of the portfolio exposed to companies below $7.5 billion in market cap. The ten largest positions, those we believe have the strongest potential for accelerated growth, accounted for 28.6% of the portfolio.

We continue to favor innovation-driven companies with differentiated secular growth themes, more domestically-oriented revenue exposure, and those with strong financials and the ability to finance growth internally. At quarter end, the portfolio's largest industry exposures were in healthcare (28.9%) and technology stocks (26.7%). Innovation in oncology, gene therapy and software-as-a-service remain strong and the portfolio reflects a particular focus in those innovative areas.

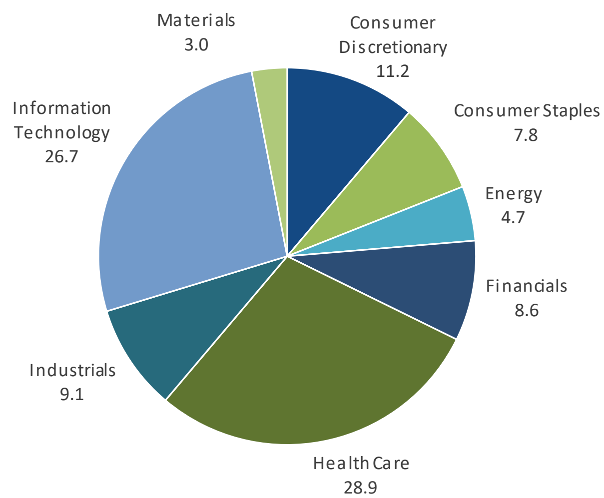
We remain vigilant in selecting companies that have secular growth drivers and high-quality management teams able to execute through a changing business climate, and where we have high visibility and confidence in future growth. We believe that the combination of equity and credit research we do provides differentiated insights that benefit our portfolios.

CHARACTERISTICS

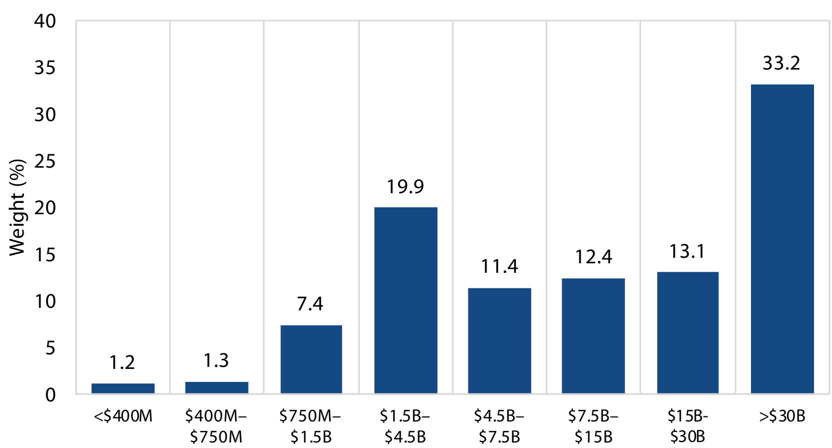
Number of Holdings	64
Top 10 Positions	28.5%
Cash Position	0.0%
Turnover (TTM)	164%
EPS Growth *(FY1/FY2 wtd. avg.)*	13.7%
EPS Growth *(3–5 year wtd. avg.)*	17.0%
Price to Earnings *(FY2)**	17.1 x
Price to Sales*	2.5 x
Price to Book*	4.2 x
Market Cap *(wtd. avg.)*	$113.7 B
Market Cap *(median)*	$8.4 B

**Weighted harmonic average.*

SECTOR WEIGHTS (%)



MARKET CAP DISTRIBUTION



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Gross and net returns, presented within were calculated in U.S. dollars on a time-weighted, total return basis, including reinvestment of all dividends, interest and income, realized and unrealized gains or losses and are net of brokerage commissions, execution costs, and any applicable foreign taxes. Accrual accounting was used for dividend income recognition. Securities transactions are accounted for on trade date. Cash and cash equivalents are included in the performance returns. The gross returns do not give effect to investment advisory fees which would reduce gross returns. The deduction of investment advisory fees will reduce gross returns and are subject to compounding. The composite results include all actual, fee paying fully discretionary accounts under management by Nicholas after one full calendar month that have substantially the same investment objectives, policies and restrictions. Unless otherwise noted the returns reflect the performance of the product composite. Performance and incentive based fees will have similar, yet often larger, impacts to performance and account values than standard management fees. Please see Nicholas' ADV Part 2A for a complete description of investment advisory fees.

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Disclosure *(continued)*

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The S&P 500 Index is a widely regarded gauge of the US equities market, that includes 500 leading large cap companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 80% coverage of available market capitalization, it is also typically used as a proxy for the total market. Index returns include the effect of dividends and income which are reinvested daily.

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