Strategy Update | 3Q 2018

US Small Cap

NICHOLAS INVESTMENT PARTNERS

Key Takeaways

- US small-cap stocks posted positive returns but lagged large caps as a rotation to more defensive positioning ensued during September. It was characterized by rising interest rates and higher volatility due to escalating trade tensions. The Russell 2000 Growth rose 5.52% versus 7.42% for the Russell 1000 Growth Index.
- Security selection was the key driver of US Small Cap's absolute and relative performance, as strong company fundamentals were rewarded.
- Innovation-driven companies in technology and healthcare and were particularly strong performers.

COMPOSITE PERFORMANCE (%)	US SMALL CAP (GROSS)	US SMALL CAP (NET)	R2000 GROWTH*
MTD	-1.90	-1.99	-2.34
QTD	6.94	6.67	5.52
YTD	21.01	20.10	15.76
1 YEAR	28.73	27.44	21.06
3 YEAR	17.01	15.84	17.96
5 YEAR	11.10	9.99	12.13
7 YEAR	18.28	17.10	17.50
10 YEAR	15.12	13.97	12.65
ITD**	9.96	8.87	9.33

**Russell 2000 Growth Index. **Composite inception date: 7/1/2007. 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.*

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.

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Small Cap Growth Landscape. Small-cap growth stocks rose on Q2 earnings and sales growth strength, racking up 36.4% EPS growth and 14.8% sales growth–the best since Q4 2010. Technology and healthcare stocks, the two largest sector groups in the index, rallied in Q3. Energy stocks fell victim to rising oil prices concerns. Other characteristics of strong performing small-cap growth stocks, based on the Russell 2000 Growth Index, included those with larger market caps and the fastest sales growth. The set up for Q3 and Q4 earnings looks good on strong US economic growth, particularly consumer spending metrics.

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 small 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.

Small caps remain in an uptrend. In addition to the upward revisions in small cap earnings and revenues, we expect small caps to benefit from earnings growth that we noted earlier.

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PERFORMANCE ATTRIBUTION

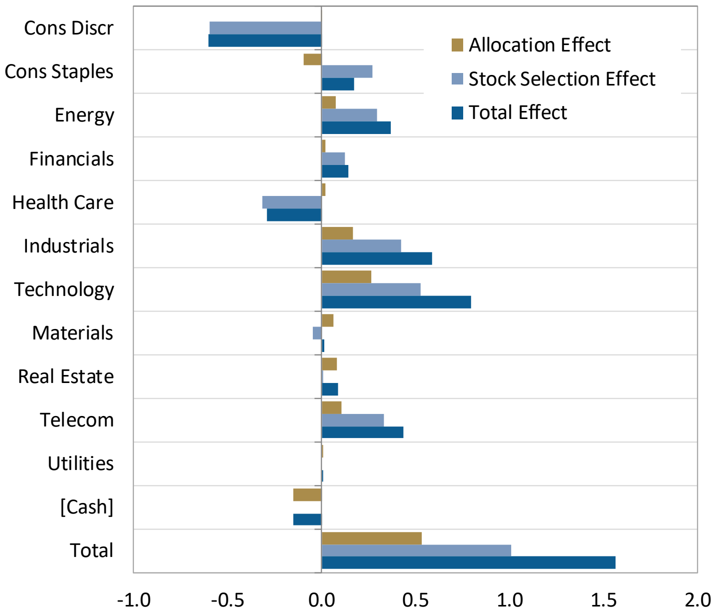
The US Small Cap portfolio closed Q3 in positive territory and beat the Russell 2000 Growth benchmark for the 7th consecutive quarter. Positive contribution to absolute returns was broad-based across sector groups, with the exception of materials. Strength in technology, healthcare and industrial holdings lifted portfolio performance the most in Q3, particularly software, medical equipment and machinery positions.

The five largest contributors to absolute returns included Callaway Golf (golf clubs, balls and accessories), Viking Therapeutics (clinical-stage therapies to treat metabolic and endocrine disorders), Teladoc Health (remote and mobile tele-healthcare services), Harsco Corp (metal fabrication) and Novocure (disruptive cancer cell treatments). Callaway Golf continues to execute on plan and is expected to realize strong top-line growth and market expansion on improving industry trends. Teladoc continued to benefit from strong revenue growth supported by higher membership and utilization trends, and reported better-than-expected revenue growth in Q2. In the case of Harsco, shares rose on higher-than-expected Q2 EPS growth as improving rail margins with new products lifted profitability.

The five largest detractors from absolute returns were OptiNose (drug treatment for chronic sinusitis), Visteon Corporation (electronic automotive components), Supernus Pharmaceutical (treatments for central nervous system disorders), At Home (home décor), and AxoGen (surgical solutions for nerve damage repair). 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. In the case of Supernus, the stock traded off after reporting Q2 in line with expectations but did not beat. Subsequently a short story circulated suggesting competitive pressures from a new class of migraine drugs may dampen further upside to the stock. We sold the position to reduce risk in the portfolio given the lack of additional near-term catalysts. Axogen declined on lower-than-expected Q2 results. We sold the position. Subsequently, the stock was the target of a short thesis of rising competition in the nerve repair space and weaker demand than management projected. The stock has continued to underperform as of this report. In terms of the other holdings that detracted, we believe their pullbacks during Q3 were short term in nature. Their underlying growth catalysts and fundamentals remain intact, so we continue to hold these positions.

Relative to the Russell 2000 Growth benchmark, stock selection in technology, industrials and telecommunication services drove outperformance during the quarter, particularly software and machinery holdings. An overweight to software and underweight to industrials also boosted relative returns. Portfolio positions in consumer discretionary and healthcare stocks subtracted the most from active returns, particularly pharmaceutical holdings.

Performance Attribution vs. R2000 Growth 3Q 2018



5 Largest Absolute Contributors/Detractors 3Q 2018

TOP 5	AVG WEIGHT (%)	CONTRIB TO RETURN*
Callaway Golf Company	3.13	0.83
Viking Therapeutics, Inc.	1.15	0.76
Teladoc Health, Inc.	1.76	0.73
Harsco Corporation	2.53	0.61
Novocure Ltd.	1.06	0.58

BOTTOM 5	AVG WEIGHT (%)	CONTRIB TO RETURN*
OptiNose, Inc.	1.06	-0.89
Visteon Corporation	1.19	-0.37
Supernus Pharmaceuticals	0.46	-0.32
At Home Group, Inc.	1.61	-0.29
AxoGen, Inc.	0.60	-0.24

Contribution to portfolio absolute return.

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

Reflecting our focus on innovation-driven dynamically growth companies, the US Small Cap portfolio has a 19.0% EPS Growth (FY1/FY2 wtd. avg.) and trades at 19.1x P/E (FY2 wtd. harmonic avg.). We believe the growth estimates for many of our holdings are understated. This compares to the Russell 2000 Growth Index's earnings growth of 19.8% with 17.8x P/E. Indicative of our fully invested, active approach the portfolio's cash level was 0.9% at month end. The ten largest positions, those we believe have the strongest potential for earnings and revenue acceleration, accounted for 23.1% of the portfolio, not materially different from the prior quarter.

As of September 30, 2018, the US Small Cap portfolio's largest sector exposures remain in healthcare, technology and consumer discretionary, although we selectively trimmed and/or sold positions to take profits in stocks where the price fully reflected their growth catalysts and, in our view, were trading above their historical averages. The portfolio was overweight in technology (+7.4%) and consumer staples (+5.5%) stocks and underweight in industrials (-10.6%) versus the Russell 2000 Growth Index. Software as a service (SaaS) stocks, in particular, accounted for nearly 580 basis points of the portfolio's technology overweight. These companies trade on price-to-sales, as opposed to earnings growth.

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. Within technology specifically, the portfolio's exposure is predominately expressed in cloud computing, software-as-a-service (SaaS) and internet services holdings. We believe high-tech capex spending is gaining momentum, providing a sustainable growth catalyst that may help drive earnings and/or revenue growth acceleration for these companies. We also believe these companies may be more isolated from global trade wars.

We remain vigilant in selecting those 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 earnings. We believe that the combination of equity and credit research we do provides differentiated insights that benefit our portfolios.

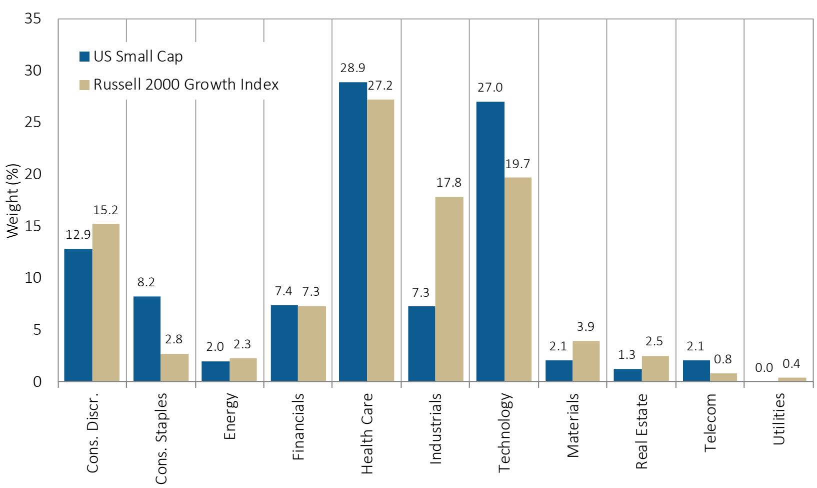
Portfolio Characteristics

SUMMARY	US SMALL CAP
Number of Holdings	95
% Active Share	89.2
% Off Benchmark Weight	33.2
% of Equity	99.1
% of Cash	0.9

CHARACTERISTICS	US SMALL CAP	R2000 GROWTH
EPS Growth (FY1/FY2 wtd. avg.)	19.0%	19.8%
EPS Growth (3–5 year wtd. avg.)	16.1%	16.2%
P/E (FY2 wtd. harmonic avg.)	19.1 x	17.8 x
P/B (wtd. harmonic avg.)	4.0 x	4.1 x
Market Cap (wtd. avg.)	$3.2 B	$2.7 B
Market Cap (median)	$2.5 B	$1.0 B

TOP 5 HOLDINGS	SECTOR	WEIGHT (%)
Harsco Corporation	Industrials	3.15
Callaway Golf	Consumer Discretionary	3.07
Kemper Corporation	Financials	2.40
SkyWest, Inc	Industrials	2.17
Moelis & Co.	Financials	2.16

Sector Weights



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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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.

Disclosure *(continued)*

Net returns reflect the deduction of the highest investment management fee for the product, which is 1.00%. Actual fees charged may vary by portfolio due to various conditions such as account size, client relationship, complexity, etc. Client's accounts may also be subject to additional fees unrelated to Nicholas such as custodial and administration fees, among others. Standard Management fee schedule: First $50M 1.00%, Next $25M 0.85%, Next $25M 0.75%, Thereafter 0.65%.

The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the US equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

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