Stephens
Investment Management Group®
The Power of Growth®

STEPHENS MID CAP GROWTH COMPOSITE

QUARTERLY COMMENTARY
FIRST QUARTER 2022

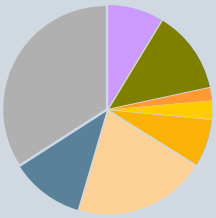
TOP 10 HOLDINGS[1]

COMPANY	% of PORTFOLIO
1. Cadence Design Systems, Inc.	2.52%
2. Palo Alto Networks, Inc.	2.33%
3. ICON, Plc	2.24%
4. Fortinet, Inc.	2.08%
5. IDEXX Laboratories, Inc.	1.83%
6. Copart, Inc.	1.82%
7. DexCom, Inc.	1.81%
8. Microchip Technology Inc	1.77%
9. ResMed Inc.	1.76%
10.Tradeweb Markets, Inc.	1.74%

Excludes Money Market Fund Holdings. Portfolio holdings and asset allocations are subject to change and are not recommendations to buy or sell a security. Current and future portfolio holdings are subject to risk.

SECTOR WEIGHTINGS[1]

Communication Services	8.69%
Consumer Discretionary	12.93%
Consumer Staples	1.98%
Energy	2.90%
Financials	7.40%
Health Care	20.62%
Industrials	11.39%
Information Technology	34.09%
Materials	0.00%



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MARKET OVERVIEW

It's amazing how different the world is at the end of this quarter than at the beginning. Omicron came and went. Inflation went from transitory to maybe not transitory to a serious problem with which the Fed would aggressively combat. Speaking of combat, real combat broke out in Ukraine, and World War III seems like a possibility.

It should come as no surprise that the bond market did not like these developments. Interest rates moved higher as the Fed signaled a more hawkish stance, and then delivered a 25 basis point hike to the Fed Funds rate, while also wrapping up their QE program. Yields on the 10-year treasury jumped almost 1%. Mortgage rates climbed even more.

Equity markets were just as troubled. The S&P 500® Index lost 4.6% of its value. Smaller companies and those with a growth focus (and higher valuations) suffered more. The Russell 2000® Index was down 7.53% and the growth version of that index was down 12.63%.

The inflation situation became much more complicated as the situation in Russia and Ukraine unfolded. The conflict will directly impact wheat production in the area. And the result of economic sanctions creates pressure on oil and natural gas prices. So, in addition to a troubling underlying inflation rate, we now have a price shock for food and energy.

There is no clear consensus among economists and market strategists, but some are now forecasting a recession – the Fed is tightening and price shocks are cutting into disposable income. The risk is very real. For now, the economy is still very hot, too hot perhaps.

MID CAP GROWTH COMPOSITE PERFORMANCE

Expensive, long duration assets took the brunt of this quarter's sell-off. Small and mid cap growth stocks were the worst performers across domestic equities. Value strategies' larger exposure to Energy vastly helped their relative returns. Gross of fees, our strategy was able to squeak out a modest 19 basis points of relative performance. The Stephens Mid Cap Growth Composite was down 12.39% (-12.49% net) for the quarter.

Communication Services stocks were down more than the broad market. Although all of our stocks were down in absolute terms, we managed to significantly outperform those in the benchmark. We sold our positions in Roku, Inc. and in IAC/ Interactive Corp.

Consumer Discretionary stocks were also hard hit, and this sector was down the most for us. This quarter, we faced the year-over-year comparison against aggressive fiscal stimulus, coincident with rising inflation and big jumps in food and energy prices. Our underweight positioning helped, but the sector was still a drag on returns. Among our holdings, we haven't seen any deterioration in demand, but some companies have struggled with costs, both for raw materials and for transportation. Farfetch Limited was our single biggest negative contributor to returns, but we used the weakness to add to the position – while they face some potential short-term weakness, they are building a more durable business franchise.

Energy was the top performing sector by a huge margin. The Russian/Ukrainian conflict set off a series of economic sanctions and the realization of the dependence on Russia for hydrocarbons. It seems as if the push for clean and renewable energy sources has created a shortfall in investments for more traditional energy sources. Crude oil and natural gas prices spiked. We believe that while the Russian conflict may or may not be short-lived, the underinvestment is a secular problem, and a new energy cycle may be underway. We added to our existing holdings and initiated a new position in Baker Hughes Company, an oilfield service provider.

Financials couldn't escape the downdraft. Our bank holdings, Signature Bank and SVB Financial Group struggled as the yield curve had flattened. Ryan Specialty Group Holdings, a specialty insurance company was down only slightly, and helped our relative returns.

Healthcare was a source of relative strength for us again this quarter. Biotechnology stocks continued to suffer, and our minimal (and profitable) exposure here served as a differentiator. Several of our Healthcare stocks seem to be benefitting from the tailwind of pent-up demand following a nearly two-year hiatus on many elective procedures and even routine check-ups. Pacira Biosciences' non-opioid pain management products saw some of this increased demand.

Industrials were particularly difficult this quarter. We saw pull backs with some of the big winners of 2021, either because of valuation concerns or the market starting to price in recession fears. Logistics and transportation companies were relative bright spots.

Technology normally has a big impact on performance, but this quarter our results were essentially in-line with the benchmark. Within software, we continue to benefit from our exposure to cyber security companies. Mandiant, Inc. was acquired by Google for a healthy premium, and it was one of our top contributors. Fellow cybersecurity company, Palo Alto Networks was a top performer as well. We took advantage of volatility, adding a new position in Teradyne Inc., a leader in the semiconductor capital equipment industry. We also initiated a position in CrowdStrike Holdings, another important player in network security.

[1]The information is shown as supplemental only and complements the full disclosure presentation located on the back. The Russell Midcap® Growth Index measures the performance of those Russell Midcap® companies with higher price-to-book ratios and higher forecasted growth values. You cannot invest directly in an index. The S&P 500® Index is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. *Copyright © 2022, S&P Global Market Intelligence (and its affiliates as applicable). All rights reserved.* *See additional information regarding S&P ratings at https://www.stephensimg.com/terms-and-conditions/ The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000® Index. You cannot invest directly in an index.*
** See our attached GIPS Report*

PORTFOLIO CHARACTERISTICS[1]

We added five new positions and eliminated eight, although two of those were companies that were acquisition targets. Sector weights for our two biggest sectors were virtually unchanged. Technology remains our largest at 33% and Healthcare stands at 20%. Industrials shrank to 11%, and Consumer Discretionary took over the third place at almost 13%. Despite the increase, we are still underweight Consumer Discretionary, along with Industrials. We are overweight Communication Services and Healthcare.

Given the negative returns for the period, it isn't surprising that valuations came down. Our weighted harmonic average P/E ratio is now 28, down from 33 last quarter. Revenue growth remained robust at 20% for the most recently reported results, but earnings growth couldn't quite keep up – inflationary pressures, tight labor markets, and expensive transportation costs hit many companies on the bottom line.

In part because of trading activity, but also because of relative performance, *core growth* exposure expanded to nearly 64%, and *earnings catalyst* stands at 36%.

OUTLOOK

We've got a lot to talk about. There's so much to cover, so many moving parts, so much complexity, I'm not sure I'll be able to get to it all. So, I thought I should be very clear about my thesis upfront. What's the one takeaway, in case you don't read the whole thing?

The future is unclear, and I mean ***really*** unclear, but what is clear: there is some pain ahead.

Let's start with an update on inflation.

If you've been reading these commentaries for the past couple of years, you know I've been concerned about the massive amounts of stimulus, both fiscal and monetary. Specifically, my concern comes from one of the most elementary concepts in economics: there is no free lunch. There is always a trade-off. Maybe the trade is worth it, but you need to understand what it is that you're trading away. Sure, there's no doubt that the various monetary and fiscal programs to support the economy throughout the COVID pandemic helped boost our economy in that moment. Do we know what we traded away? What is the cost of that "lunch"? When will the bill come due?

It didn't surprise everyone that inflation is one of the costs. The fact that it did surprise so many, our policy makers included, is disturbing, but it is a reminder of the importance of understanding behavioral biases. I argued over a year ago that the inflationary pressures were ***both* transitory and structural**. I still believe that with most complex issues, the answers are similarly complex – it's usually not either/or. Those on "team transitory" were suffering from confirmation bias (among others). It was easy to build a narrative that inflation would be short-lived, and then go find evidence to support that. The problem is that there was also plenty of evidence that inflation would be more persistent.

Late last year, team transitory relented. In the last few weeks, they've completely reversed their stance, and are explicitly posturing as very hawkish, with talk of multiple 50-basis point hikes, and an aggressive pace of QT. I'm not sure if they really believe this, or if they're just trying to regain investors' confidence that they will do what it takes to tame inflation. We have been worried what would happen if inflation expectations became unanchored. The Fed seemed to take it as a given last year, but no longer. The expectations aren't nearly settled yet, and this is perhaps the frontline of the policy battle.

Part of the confusion on inflation last year stemmed from the debate about the *source* of inflation. Team transitory was insistent that it was a *supply* problem – COVID restrictions, component shortages, logistical bottlenecks. Again, confirmation bias kicked in, and it was easy to find evidence supporting this theory. Given our focus on behavioral economics, on our research checklist is a concerted effort to find data that would contradict or refute a theory, or data that would support an alternate theory. It was very easy to find evidence that the inflation problems were being driven by excess demand: Factories running at full tilt and still not making enough, semiconductor shipments at record highs (despite the so-called shortages), throughput at the ports of Long Beach and Los Angeles at or near record highs. These are the signs of demand-pull inflation. I'll once again refer you to my theory that in complex situations, the answer is almost never either/or, it's both!

Now we're getting somewhere. Sure, there were some supply constraints, but there was also an abnormal amount of demand. Why? The answer to this question is multifactorial as well. There is no doubt that COVID shifted some demand from services to goods. I think it's reasonable to assume that this is a temporary phenomenon: we pulled forward demand for some durable goods, and we held up demand for many services; this should reverse. Perhaps the more impactful demand driver was economic stimulus. Direct transfers, PPP loans, child tax credits, and enhanced unemployment benefits put enormous sums of money into consumers' hands. That money got spent…mostly on goods. The policies of 2020 and 2021 were about as close to "helicopter money" as our economy has ever seen. 2022 will be a year without money raining down from above. As we move from a year of excess demand to a year of stimulus hangover, some of the transitory nature of this inflation will subside.

Let's not forget about the other components of inflation, some of which are structural. For decades, we have experienced deflation for goods, as many companies have taken advantage of cheap labor overseas, in China and Southeast Asia specifically. It has taken a very long time, but wages in those countries have risen to a level where in many cases we are at or near parity with domestic manufacturing when you consider other costs such as transportation, time to market, quality control, intellectual property protection, and so on. **The low hanging fruit of global wage arbitrage has been plucked**. At the same time as natural market forces are leading us toward more domestic manufacturing, the lessons of COVID and of recent geopolitical conflict point to the same solution: there is a political push to produce more domestically. It's hard to argue with that logic. However, **as with all things, there is a trade-off**. In this case, we can no longer exploit that cheap labor. A manufacturing renaissance here in the US will create jobs and enhance national security, but it comes at a higher cost – a higher cost, literally: inflationary pressure that is *not* transitory. Secular disinflationary tailwind of globalization is over.

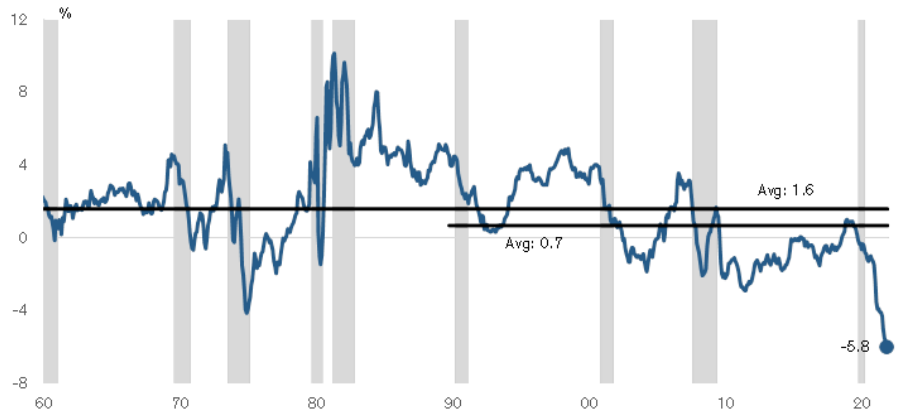
I'd be remiss if I didn't point out that the policies of the Federal Reserve have also contributed to inflationary pressure. The economist, John Taylor, developed the Taylor Rule to help central banks appropriately set short term rates. It's far from perfect, but most economists agree that it is a fundamentally sound framework to help guide interest rate policy. As I write this, the Taylor Rule would recommend a Fed Funds rate of 10.5%. That's not a typo.

OUTLOOK

As inflation rages and the Fed leaves nominal short term rates unchanged (except for the 25-basis point increase in March), real rates become **more** negative. Fed *inaction* in the face of inflation leads to policy which is implicitly **more** accommodative. Real interest rates are becoming more negative. I'm not sure if this should be considered a structural problem, but it won't be a transitory problem until the Fed gets real rates into positive territory. And even then you will have to wait roughly 12 months for that to impact the actual economy. Suffice it to say that the Fed has been way behind the curve, and the inaction and dismissive attitudes last year are surely policy error.

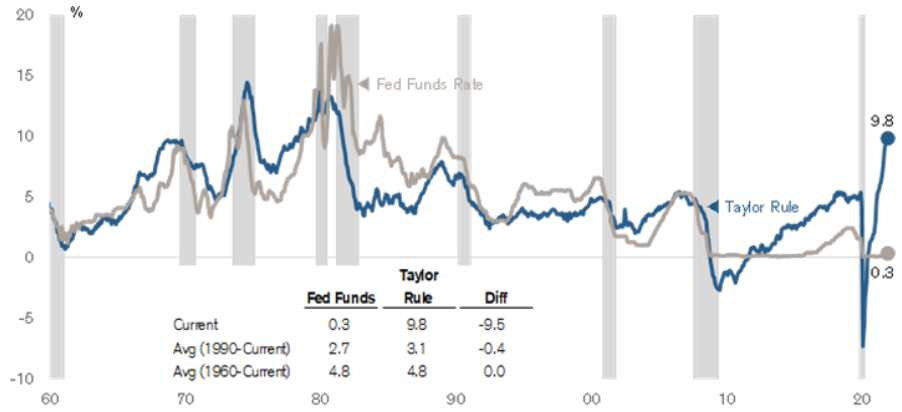
Jonathan Golub, Chief US Equity Strategist at CS First Boston, put together these two charts on March 29th. The first is what the *real* Fed Funds rates have been.

Real Fed Funds Rate



And then what the Taylor Rule would indicate the Fed Funds rates should be.

Taylor Rule Estimate vs. Fed Funds Effective Rate



	Fed Funds	Taylor Rule	Diff
Current	0.3	9.8	-9.5
Avg (1990-Current)	2.7	3.1	-0.4
Avg (1960-Current)	4.8	4.8	0.0

Taking all this in, it sure seems like higher inflation is here to stay for a while. The Fed is behind, and the policy changes they make this year won't really impact the economy for 12 months or so. But before we close this chapter, we need to talk about World War III.

I'm only half serious when I say World War III. Clearly, this war isn't anything like the prior World Wars, but it has drawn in most developed countries. While conflict on the ground is limited to Ukraine, the economic conflict (and to a lesser extent, the cyber conflict) is truly global. Commodity markets are reeling from the result of sanctions on Russia. Oil, natural gas, wheat, and steel prices have all been materially affected.

The timing of these price shocks is pretty terrible. I say "price shocks," because I don't believe this is a direct result of inflation. There are exogenous factors disrupting the normal flow of commodities. Admittedly, it's hard to disentangle the war-related impact on prices from the pre-existing inflationary pressures**. Prior to this shock, I think you could have made a reasonable case for a wage-price spiral and a continuation of inflation until the Fed's actions finally caught up with the situation. Now, I'm not so sure**. These moves in energy and food prices have quickly been passed on to consumers and are crowding out other spending. Wages weren't quite keeping up with inflation to begin with, but this shock makes things much, much worse.

OUTLOOK

We are already seeing early signs of the impact. In February, total Consumer Credit jumped by an amount that is the highest on record. Credit card data shows slowing retail transactions. Consumer confidence has fallen to levels not seen in over a decade. Some economists are forecasting a recession.

Economist Scott Sumner's recent blog post stated this:

> *Milton Friedman and Anna Schwartz wrote a very long history of monetary policy in the US. Allan Meltzer wrote a very long history of the Federal Reserve. Want a Cliff's Notes version of the two books? How's this for a summary:*
>
> *Once again, the Fed was behind the curve.*

I agree. The Fed was behind starting in Q4 of 2020. It astonishes me that they were still implementing QE until a few weeks ago. You've seen the chart above where the Taylor Rule shows you just how behind they are.

The only positive is the dark humor we can draw from the incredible irony of it all. The Fed finally gets religion on inflation at a time when the average consumer is struggling. Just recently, Lael Brainard was very vocal about aggressive Quantitative Tightening that will begin this summer, and conveyed that 50- basis point hikes should be expected. So now we begin the aggressive tightening, right when the average consumer is struggling to make ends meet. Wages haven't kept up with inflation, repercussions of a war on another continent have sent energy and food prices skyrocketing, and the average consumer has a bit of a hangover from last year's stimulus largess. The most recent data on disposable income, in real terms, is down on a year-on-year basis more than ever before.

Yet again, the Fed might already be behind the curve. But I'm not sure they have a choice. They've painted themselves into a corner, dealing with the costs, the trade-offs, of prior choices.

It's a tough combo: inflation (as in reduced purchasing power of the dollar), shortages of key goods (and I would argue that shortages are simply unrealized inflation), price shocks, deterioration in real wages and disposable income, all at a time when the Fed is going to tighten the screws. Stagflation? Recession? I don't think anyone really knows.

The macroeconomic situation is as uncertain as I've ever seen. The one thing I feel certain about is that there are some rapidly changing factors that will create both disruptions and opportunities across the economy, and that in turn will lead to dispersion of performance across equity markets.

It's worth spending a little time on how we are positioned, emerging themes, and what we are doing to deal with this dynamic environment.

1. For years, given our concerns about inflation, we have focused on companies which we believe have pricing power. As inflation ramped up, and there is no more debate, everyone talks about pricing power now. It's become cliché. If you have ever seen the Pixar movie *The Incredibles*, there's a line from the movie's villain where he says, "When everyone is special, no one is."
   Pricing power is the same way. When everyone has pricing power, that's called inflation. So, let me be clear regarding our endeavors: we are scrutinizing companies to see if they have relatively inelastic demand. So that when prices go up, they won't be subject to substitution or faltering demand.

   Last year, nearly every company raised price, with very little push back. That will not be the case in 2022. As conditions tighten, not everyone will be able to raise price.

2. We are dusting off the playbook from 2008-9. When the recession came, and more specifically, when consumers were constrained by falling disposable income, there were many stocks that suffered, but there were some stocks that gained share or advanced because of the substitutions and changes consumers were making.

3. Supply chains and manufacturing itself is evolving. More manufacturing is moving to the USA and North America. This will create economic opportunities. Still reeling from COVID setbacks and shortages, many supply chains are evolving, and the bias is for higher inventory. There are business model implications.

4. It seems as if the housing market might be the most important piece of this economic puzzle. While we don't have much direct exposure to housing, we are paying close attention because of the cascade of implications for so many aspects of the economy. As complicated as the whole economic situation is, the housing market is just as complex. There is significant migration within the US, for political reasons and economic, and the work-from-home trend enables this on a scale we have never seen before. Higher mortgage rates may dampen demand, but in an inflationary environment, people may have even more demand for an appreciating asset, when real interest rates are still negative. There is some regional cost of living arbitrage that might mitigate the impact of rising rates.
5. Right now, it is difficult to differentiate between actual weakness and deteriorating demand versus unusual year-over-year comparisons resulting from last year's stimulus.

We are still as focused as ever on our bottom-up process, searching for great, secular growth companies, where other investors are underestimating the magnitude or the duration of their opportunities. But we are also focused on the macro environment and the potential disruption from policy makers. These events will create even more volatility and more dispersion. Volatility and dispersion never feel great in the moment, but for investors with a long term focus, these are wonderful gifts.

GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS) REPORT

Year	Total Firm Assets (millions)	Strategy Assets*		Composite Assets		Advisory-Only Assets*	Annual Performance Results				3 Yr Annualized Standard Deviation	
		USD (millions)	Number of Accounts	USD (millions)	Number of Accounts	USD (millions)	Composite Gross	Composite Net	Russell Midcap® Growth	Composite Dispersion	Composite Gross	Russell Midcap® Growth
2020	6,916	975	25	878	22	97	41.77%	41.09%	35.59%	0.34%	22.26%	21.45%
2019	5,416	654	17	263	13	28	33.57%	32.85%	35.47%	0.29%	14.79%	13.88%
2018	4,301	342	13	216	11	11	3.22%	2.68%	-4.75%	0.12%	14.13%	12.82%
2017	4,442	338	12	240	11	0.00	29.68%	29.01%	25.27%	0.20%	11.72%	10.88%
2016	3,644	287	13	201	9	0.46	7.98%	7.24%	7.33%	0.09%	13.13%	12.17%
2015	2,897	152	12	38	10	0.44	-0.27%	-1.01%	-0.20%	N.A.	12.01%	11.29%
2014	3,430	165	6	31	4	0.43	4.19%	3.40%	11.90%	N.A.	11.71%	10.87%
2013	3,054	155	6	35	4	0.41	34.63%	33.60%	35.74%	N.A.	13.54%	14.62%
2012	1,222	85	6	7	2	0.36	16.74%	15.78%	15.81%	N.A.	16.44%	17.91%
2011	933	40	3	1	1	0.32	3.26%	2.44%	-1.65%	N.A.	18.13%	20.82%

•Strategy Assets are shown as supplemental information as these assets include composite assets and advisory-only assets, and include advisory-only UMA assets managed within the Mid Cap Growth Strategy.
N.A. – Composite Dispersion information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.

The investment objectives, risks, charges and expenses should be carefully considered before investing. SIMG nor their representatives provide legal or tax advice. Please consult your tax advisor before making any decisions.

There are additional risks associated with investments in smaller and/or newer companies because their shares tend to be less liquid than securities of larger companies. Further, shares of small and new companies are generally more sensitive to purchase and sales transactions involving the company's stock and to changes in the company's financial condition or prospects, and, therefore, the prices of such stocks may be more volatile than those of larger company stocks. Clients' investment results and principal value will fluctuate.

Mid Cap Growth Composite *contains fully discretionary accounts and pooled investment vehicles invested primarily in mid cap common stock of U.S. companies. Under normal market conditions, most of the securities purchased for this composite have market capitalizations between $1.0 billion and the market capitalization of the largest company in the Russell Midcap® Index at the time the security was initially purchased by accounts in the composite which appear to have clear indicators of future earnings growth or that appear to demonstrate other potential for growth of capital. In addition to common stock the composite may also purchase convertible and preferred stock as well as certain Exchange Traded Funds. This composite is actively managed and securities in the composite are frequently purchased and sold by the manager. For comparison purposes the composite is measured against the Russell Midcap® Growth Index.*

Stephens Investment Management Group, LLC claims compliance with the Global investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Stephens Investment Management Group has been independently verified for the periods December 1, 2005 through December 31, 2020. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The *Mid Cap Growth Composite* has had a performance examination for the periods June 2, 2006 through December 31, 2020. The verification and performance examination reports are available upon request.

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Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results.

The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of fees and include the reinvestment of all income. Net of fee performance is calculated using actual fees incurred. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.

The management fee schedule begins at 1.00% of assets under management. Actual investment advisory fees incurred by clients vary.

The Mid Cap Growth Composite creation and inception dates are June 2, 2006.

Prior to September 1, 2011, composite policy required the temporary removal of any account from the composite which incurred a client initiated significant cash inflow or outflow of 10% or more of the value of the net assets of the account in any 30 day period. The temporary removal of such an account occurred at the beginning of the month in which the significant cash flow occurred and the account re-entered the composite at the beginning of the month after the cash flow. This policy was deleted effective September 1, 2011. Additional information regarding the treatment of significant cash flows is available upon request.

The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. The three-year annualized ex-post standard deviation of the composite and annual composite dispersion are calculated using gross-of-fees returns.

Certain accounts in this composite direct trading to broker-dealers that execute trades for no commission. Assets in these accounts are 4.57% of total composite assets as of December 31, 2020.

This composite was redefined January 1, 2020 to include pooled investment vehicles following SIMG's Mid Cap Growth Strategy.

Prior to January 1, 2020, this composite was known as the Mid Cap Growth Separate Account Composite.

Firm AUM does not include accrued dividends.

A list of composite descriptions, a list of limited distribution pooled fund descriptions and a list of broad distribution pooled funds are available upon request.

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