Stephens
Investment Management Group®
The Power of Growth®

STEPHENS SMALL CAP GROWTH SEPARATE ACCOUNT

# QUARTERLY COMMENTARY
## FOURTH QUARTER 2018

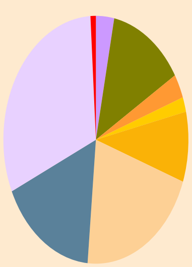
## TOP 10 HOLDINGS[1]

| COMPANY | % of PORTFOLIO |
|---|---|
| 1.ICON Plc | 2.07% |
| 2.Five9, Inc. | 1.63% |
| 3.Proto Labs, Inc. | 1.62% |
| 4.Omnicell, Inc. | 1.62% |
| 5.Semtech Corporation | 1.60% |
| 6.HEICO Corporation | 1.60% |
| 7.Aaron's, Inc. | 1.58% |
| 8.Green Dot Corporation | 1.57% |
| 9.Wingstop, Inc. | 1.56% |
| 10.Trex Company, Inc. | 1.56% |

*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 | 3.18% |
| Consumer Discretionary | 13.12% |
| Consumer Staples | 3.14% |
| Energy | 1.92% |
| Financials | 9.14% |
| Health Care | 20.94% |
| Industrials | 16.74% |
| Information Technology | 30.89% |
| Materials | 0.94% |



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## MARKET OVERVIEW

Over the last several quarters, we referred to a continuation of the trends from the prior quarter. Q4 of 2018 was certainly not a continuation of the prior trends.

On the surface, the economy seemed to be doing well still: unemployment remained below 4%, and although corporate earnings slowed a bit, they were still at healthy levels. Leading economic indicators started to deteriorate, however. Higher interest rates slowed the housing market. Trade concerns over increased tariffs started to seep into the economy as well. Globally the economic outlook slowed. Brexit caused pains; Europe is still slow going; and China appeared to be slowing significantly.

With a ten year old bull market, restrictive monetary policy (both in terms of rates and quantitative tightening), and signs of a slowing economy, investors were quick to take money off the table. The result was a 13.52% drop in the value of the S&P 500® Index. Small cap companies were hurt even more, as the Russell 2000® Index lost over 20% of its value just in the fourth quarter.

The market seemed to be pricing in a recession.

## SMALL CAP GROWTH SEPARATE ACCOUNT COMPOSITE PERFORMANCE

In absolute terms, performance was pretty terrible across the entire market: small or large, growth or value, it was all down double digits.

We had been concerned given our strong relative performance through the third quarter, that we might be particularly vulnerable in a sharp sell-off. We are clearly unhappy with the absolute returns, but we are pleased to report that we were able to outperform our benchmark. The Russell 2000® Growth Index was down 21.65%, while the Stephens Small Cap Growth Composite fell 20.59% (20.72% Net).

As the market sell-off intensified, it became more liquidity-driven. Money was coming out of equity markets for both active and passive alike. As managers were forced to sell their holdings across the board, correlations increased, and thus there was little dispersion across many of the factors we normally examine, with the exception of market capitalization – the smaller the market cap, the less liquid, and thus the more impacted. Micro-cap stocks were decimated.

Our Consumer Discretionary stocks were roughly in-line with those in the benchmark. Wingstop, Inc. continued its robust relative performance, although we used that backdrop to take profits and reduce our position as a matter of risk control. Chegg, Inc. was a top contributor, as its online educational platform seemed resistant to near-term economic concerns.

As it has been for the last several quarters, our Energy exposure was fairly limited, and thus its impact on the portfolio was similarly reduced. Crude oil prices sold off precipitously throughout the quarter, indicative of weakening global demand. Natural gas prices did quite the opposite due to a combination of cold weather and reduced inventory levels.

We modestly outperformed in Financials this quarter. Banks were trading as if we are headed for another financial crisis, which is very unlikely. Our belief is that quantitative strategies using the last recession as a guide for what might be the next are assuming that financials will trade the same way. The reality is that the banking industry is much healthier and better capitalized now. We have been opportunistically building positions in the sector and in particular with Encore Capital Group, Inc. and PRA Group Inc.

Most of our outperformance came from Healthcare, as our underweight position in Biotech helped. You may remember that last quarter, we had been trimming our position in Ligand Pharmaceuticals Incorporated, as it was our single biggest contributor to returns then. Those sales proved very effective, as the stock sold off throughout Q4. We began to add back to the position on weakness. We sold our stake in athenahealth, Inc. on news that they were being acquired by a private equity firm.

We had relative strength in Industrials as well. Our bias toward secular growth companies means that we tend to avoid the more cyclical companies in the sector. As economic fears mounted, it impacted those cyclical companies more.

As our largest sector, Technology contributed to our outperformance in a meaningful way as well. Most of our success was a result of our holdings in software issuers. Five9, Inc. was one of the few stocks that actually had positive returns for the quarter. The cloud-based contact center software provider posted one of its best quarters since its IPO.

## PORTFOLIO CHARACTERISTICS

We added two new positions and eliminated four this quarter. With fairly low turnover, our sector weights didn't shift much. Technology, Healthcare, and Industrials remain our three largest at 30%, 20%, and 16% respectively. We are still overweight Technology and underweight Healthcare (because of Biotech), Real Estate, and Materials.

As the market pulled back, valuations retrenched as well. Our weighted harmonic average P/E on next twelve months earnings moved from 28.5 to 22.6! That same statistic for the benchmark fell from 19.3 to 16.2. Expectations for growth slowed as well, in part because of the year over year comparisons versus last year's tax cuts. Actual growth remained robust however. Our median company posted 34.5% earnings growth and 16.4% revenue growth in the most recent quarter. Our benchmark's median growth rates for earnings and revenues were 24.4% and 10.4%.

The mix between *core growth* and *earnings catalyst* has shifted slightly toward core. The split is now 49% core and 51% catalyst.

*[1]The information is shown as supplemental only and complements the full disclosure presentation located on the back. The Russell 2000® Growth Index measures the performance of those Russell 2000® companies with higher price-to-book ratios and higher forecasted growth values. 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.*  *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.*

## OUTLOOK

Part 1 – Battle of the bots.

In the early 2000's, Texas Hold 'Em poker was in the limelight. ESPN was broadcasting big money power tournaments on primetime TV. At the same time, online gambling was growing exponentially in part because of all the exposure.

Poker is about a lot of things, but at its root is math and probabilities. And what better to calculate the probabilities than a computer? So, it wasn't long after the boom in poker and the online poker websites, someone wrote some software to play the game on their behalf. It would always calculate the odds correctly, and then it could be programmed to bluff, implement betting strategies, and interpret other players' bets according to the software user. It's not hard to see that the computer would have an advantage over the average human player.

Eventually, someone decided they could make more money selling the software itself rather than using it to play poker. Other players jumped on board, and pretty soon it was everywhere. Online poker went from people playing one another to bots playing bots – no humans in a game.

I'm guessing that programming the bot early on wasn't hard. A good poker player would know how to exploit a novice or even average human player. But once the bots took over, I'm guessing that programming didn't work as well. Every bot had a similar approach. So then someone figured out how to re-program their bot to take advantage of the fact that the first round of bots were programmed to play against novice or average people, and that could be exploited. And then some clever fellow programmed his to take advantage of that second-order strategy. And so on and so on. (I can't help but think of the 'Battle of Wits' scene from The Princess Bride .) I'm guessing the only bot making money was the one that could consistently stay ahead of the herd – always willing to abandon the prior successful strategy at its peak. Not an easy thing to do.

Now, I don't pretend to know all the nuances of algorithmic trading or all the varieties of quantitative strategies that exist today, but I think you can see where I'm going with this. The Wall Street Journal published an article on December 25 that claimed:

> *Roughly 85% of all trading is on autopilot—controlled by machines, models, or passive investing formulas, creating an unprecedented trading herd that moves in unison and is blazingly fast.*

**Let me be clear: what we are doing isn't poker, but some days I wonder if it's a little like being the only human at the poker table, playing against all these bots that have been programmed to exploit whatever was exploitable in the last go 'round.** If active, fundamentally-based investors only represent 15% of trading volume today, how can prices be efficient? And there's no reason to think that the trends toward passive will abate anytime soon. What will the market look like when that 85% goes to 90% or 95%? We may not have to wait long to find out.

Part 2 – Yes, I am a nerd.

When I was a teenager, I was pretty serious about bicycle racing. My wonderful parents supported me as much as any parents could, driving and flying me around the country to race after race. Being a parent now, I realize what a wonderful thing it is being stuck in the car with your child for hours on end. It's a fantastic bonding experience.

I still remember some of those trips and the things we discussed. My father was a CFA, and an investment manager as well. I distinctly remember one of those trips where he explained *convexity* to me when I was about 15. I was blown away. It seemed like such a profound and interesting notion, non-obvious, and potentially a powerful tool for a bond manager. And yes, I am a nerd.

For the uninitiated, convexity describes the shape of the curve which represents the price of a bond relative to interest rates: essentially the price of a bond is more sensitive to a given move in interest rates when rates are lower. Bond prices aren't the only thing that exhibit convexity. We're really just talking about non-linear functions and second derivatives. Here's my question: how convex is U.S. economic activity with respect to interest rates? Surely a 25 basis points hike in the late '90s on a base of 5% or 6% Fed Funds rate pales in comparison to the power of a 25 basis point move when rates are at 1 or 2%. It seems somewhat arbitrary for the Fed to be using 25 basis point increments, when they clearly have different levels of power depending on current rates.

Here's an example that our friends at Cornerstone Macro published recently. On an equivalent-sized mortgage (adjusted to today's market) a 1% rise in mortgage rates in 1981 would lead to a 5.3% increase in monthly payment. A 1% move today would lead to an 11.9% increase in monthly payment.

As we all know, the Fed decided to raise by another quarter point this December, and the market did not like it one bit. The market has begun to figure out this convexity issue: it's not clear that the Fed is thinking the same way.

At the same time, the Fed continues to shrink its balance sheet. All that Quantitative Easing we enjoyed is now reversing, so that today we have a mild dose of Quantitative Tightening. It was difficult to measure the impact of QE, and it is similarly hard to determine exactly what QT is doing, but it is definitely restrictive.

To summarize, for a decade now, the Fed (and other central bankers) have been in uncharted territory, using tools they have never used before. It is still too early to understand the implications. For a while the market thought it was the "Goldilocks" solution, but now more investors are starting to believe that there may be or may have been a policy error.

Part 3 – It's the economy, stupid.

At the end of the day, the biggest question is: what's going on with the economy? In my comments above, I mentioned that it seems as if the market is pricing in a recession. We should be reminded of Paul Samuelson's famous quote, "The market has predicted nine of the last five recessions". The market can be a leading indicator, but it also gives some false positives.

From our perspective, it's just too early to tell. There are signs that the economy is slowing. The housing market has slowed. The government shutdown will have an effect. We are hitting the anniversary of the tax cuts. China's economy is definitely slowing. And the trade wars are having a real impact.

There are some facts to balance that out, however. Unemployment, while usually a lagging indicator, is still very low. Energy prices have fallen, and that puts extra money in most consumers' pockets. Inflation data is still very tame. Although the Fed hiked in December, they acknowledged that 2019 might not see any increases. Tax refunds are expected to be up significantly, as very few workers changed their withholding. Typically, those tax refund dollars get re-injected into the economy almost immediately.

## OUTLOOK

Putting it all together

My conclusion is that it's a pretty exciting time. Nearly two years ago, we made the case for active management, based on the idea that as money flows into passive, it is price-insensitive and fundamental-insensitive. It's only seeking exposure to beta or some other factor. As these dollars flow, they distort the normal price discovery process, and create inefficiency and opportunity. We hypothesized that at some critical point, it might create a golden age for active management – certainly for active management that is aware of the distortion and trying to exploit it.

Despite our recent outperformance, I do not believe that this has played out just yet. We got a taste of it in February, but money continues to move out of active and into passive. The spring is being wound tighter still.

At the same time, fundamentals are changing. The economy is changing. Market leadership is changing.

Change is good! We thrive on it. Change is opportunity.

I can't think of a time in my career with so many moving pieces, so much complication, so much noise in the system, all happening at the same time when so few investors are paying attention (being passive). Volatility and noise will rule the day in the short run, but in my opinion, the long term opportunity is as good as I've ever seen. Buckle up! I know I'm going to enjoy the ride.

**Earnings growth for a portfolio holding does not guarantee a corresponding increase in the market value of the holding or the portfolio. Earnings Growth** is a measure of growth in a company's net income over a specific period, often one year. **Return on Equity** is the amount of net income returned as a percentage of shareholders equity and measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

## IMPORTANT LEGAL DISCLOSURES

| Year | Total Firm Assets (millions) | Strategy Assets* | | Composite Assets | | Annual Performance Results | | | | 3 Yr Annualized Standard Deviation | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | USD (millions) | Number of Accounts | USD (millions) | Number of Accounts | Composite Gross | Composite Net | Russell 2000® Growth | Composite Dispersion | Composite Gross | Russell 2000® Growth |
| 2017 | 4,446 | 1,820 | 18 | 1,242 | 17 | 20.24% | 19.41% | 22.17% | 0.08% | 13.06% | 14.59% |
| 2016 | 3,658 | 1,781 | 23 | 1,174 | 21 | 11.41% | 10.62% | 11.32% | 0.10% | 15.46% | 16.67% |
| 2015 | 2,903 | 1,610 | 26 | 1,095 | 25 | -3.61% | -4.26% | -1.38% | 0.06% | 14.64% | 14.94% |
| 2014 | 3,436 | 2,198 | 29 | 1,501 | 28 | -2.31% | -2.91% | 5.60% | 0.08% | 13.59% | 13.82% |
| 2013 | 3,076 | 2,359 | 29 | 1,630 | 28 | 44.65% | 43.74% | 43.30% | 0.14% | 15.30% | 17.27% |
| 2012 | 1,222 | 1,096 | 20 | 888 | 19 | 16.99% | 16.21% | 14.59% | 0.07% | 18.00% | 20.72% |
| 2011 | 933 | 859 | 20 | 761 | 19 | 3.43% | 2.74% | -2.91% | 0.08% | 20.96% | 24.31% |
| 2010 | 919 | 878 | 18 | 779 | 16 | 27.82% | 26.98% | 29.09% | 0.05% | 25.69% | 27.70% |
| 2009 | 554 | 521 | 15 | 459 | 14 | 38.41% | 37.53% | 34.47% | 0.25% | 23.61% | 24.85% |
| 2008 | 387 | 362 | 15 | 320 | 12 | -39.92% | -40.33% | -38.54% | 0.08% | 20.87% | 21.26% |

*Strategy Assets are shown as supplemental information as these assets include mutual fund assets which are managed within the Small Cap Growth Strategy.

**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 decision.**

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 price of such stocks may be more volatile than those of larger company stocks. Clients' investment results and principal value will fluctuate.

***Small Cap Growth Separate Account Composite*** *contains fully discretionary accounts invested primarily in small cap growth common stock of U.S. companies. Under normal market conditions, most of the securities purchased for this composite have market capitalizations equal to or less than the largest company contained within the Russell 2000® Growth Index at the time the security was initially purchased by accounts in the composite and are securities of companies 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 2000® 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 September 30, 2018. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Small Cap Growth Separate Account Composite has been examined for the periods October 7, 2004 through September 30, 2018. The verification and performance examination reports are available upon request.**

Stephens Investment Management Group, LLC is a registered investment advisor specializing in equity investment management, specifically small and mid-capitalization growth companies. The firm maintains a complete list and description of composites, which is available upon request.

***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 management fees and include the reinvestment of all income. Net of fee performance is calculated using actual management fees and performance fees incurred. Prior to June 2, 2005, accounts in the composite were charged a bundled fee based on a percentage of assets under management. The bundled fee covered investment management, trading and other account expenses. Gross returns for this period are shown as supplemental information and are stated gross of all fees and transaction costs; net returns are reduced by all fees and transaction costs incurred. Policies for valuating portfolios, calculating performance, and preparing compliant presentations are available upon request.

The management fee schedule begins at 1.25% of assets under management. Actual investment advisory fees incurred by clients may vary.

The Small Cap Growth Separate Account Composite was created December 1, 2005. Performance for the period prior to December 1, 2005 occurred while the Portfolio Management Team provided services on behalf of the prior firm, Stephens Inc., and the Portfolio Management Team members were the only individuals responsible for selecting the securities to buy and sell.

Beginning September 30, 2007, composite policy requires the temporary removal of any account from the composite which incurs 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 occurs at the beginning of the month in which the significant cash flow occurs and the account re-enters the composite at the beginning of the month after the cash flow. 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.