OSTERWEIS
FUNDS

January 30, 2024

Dear Shareholder,

The Osterweis Emerging Opportunity Fund (OSTGX) roughly kept pace with the Russell 2000 Growth Index during the fourth quarter, which appreciated 12.75%. For the full year, the fund did well on both a relative and absolute basis, outperforming the benchmark by over 5%.

Performance[1] (as of December 31, 2023)

	QTR	1 Year	3 Year	5 Year	10 Year	Since Inception (10/1/2012)
OSTGX	12.06	23.98	-4.78	15.16	11.27	13.84
Russell 2000 Growth Index	12.75	18.66	-3.50	9.22	7.16	9.81

All figures in this table reflect percentages. Periods longer than 1 year are annualized.

Market Recap

Small cap growth stocks had a solid fourth quarter, fueled by the Fed's surprising decision to pause its rate hiking program in September. The rally strengthened in December, when the Fed (also unexpectedly) announced three potential rate cuts in 2024. While we believe the timing of the Fed's dovish pivot is due primarily to the steady deceleration of inflation, we also think it may have been to avoid any perception that it is trying to influence the upcoming presidential election.

Due to the Fed's dramatic policy shift, many of the best performers within the small cap growth market came from the highest beta, lowest quality stocks, which had been depressed on a valuation basis. Another class of stocks that did well were those hurt by higher interest rates such as homebuilders, regional banks, and other financials.

This is not quite what we expected to happen. As we wrote in our last letter, we thought that the post-pandemic business cycle would lose more steam before the Fed decided to cut, and that

[1] *Performance data quoted represent past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be higher or lower than the performance quoted. Performance data current to the most recent month end may be obtained by calling (866) 236-0050. An investment should not be made solely on returns. Gross/Net expense ratio as of 3/31/23: 1.25% / 1.13%. The Adviser has contractually agreed to waive certain fees through June 30, 2024. The net expense ratio is applicable to investors. See additional disclosures at the end of the letter.*

markets and the economy would soften a little. Instead, it appears that the recent pivot has pre-empted that outcome, and as such it has also boosted our near-term outlook. Moreover, we continue to think the long-term picture for small cap growth is favorable, as the historic lows of small cap stocks relative to the S&P 500 in the last few years suggest that there remains much more relative upside in our market. One quarter of double-digit gains does not get us anywhere close to catching up to the S&P 500.

Portfolio Attribution

The fund roughly kept pace with the index during the fourth quarter. Below we discuss the details of our performance.

Sector Allocation

Sector allocation was slightly additive to our relative performance during the fourth quarter. Our underweight to Energy had the biggest positive impact, as falling oil prices caused the sector to underperform versus the overall index. Our overweight to Technology, Health Care, and Real Estate was also additive, as each of these sectors in the index outperformed. Our underweight to Consumer Discretionary was a minor drag, as that sector beat the overall index.

Security Selection

Security selection detracted from our relative performance but only marginally. Our stock picks within Consumer Staples, Industrials, and Consumer Discretionary were our strongest relative performers, as each sector beat their counterparts in the index. On the downside, our stock picks within Financials, Technology, Real Estate, and Health Care worked against us.

In the Consumer Staples sector, our top performing stock was e.l.f. Beauty (ELF), a global cosmetics company. ELF's low-priced product innovation engine continues to run aggressively, and the company has also successfully entered the skincare market. It is already taking share from established competitors and growing over 100% year-over-year, though off an admittedly small base. In addition, the firm's international expansion is just beginning, with global sales representing a small portion of the company's total revenue. We believe that ELF can double market share in the U.S. from today while increasing their international sales by multiples in the coming years.

Our only detractor in this sector, albeit small, was Chefs' Warehouse (CHEF), a specialty food distributor. We exited the stock due to ongoing concerns about a general slowdown in the "center of plate" pricing levels across the restaurant industry. We redeployed the capital into other, more promising consumer businesses, including the energy drink manufacturer, Celsius Holdings (CELH), which more than doubled its year-over-year domestic sales growth as of December.

Our biggest contributor to the Consumer Discretionary sector was Cavco Industries (CVCO), a builder of manufactured homes. CVCO performed well this quarter as rates fell, which drove improved sentiment for housing stocks. After bottoming early this year close to 80,000 annual units, manufactured housing data suggest the October annualized rate has improved to nearly 95,000 (seasonally adjusted). We like this trajectory and expect recent trends in rates as well as affordability advantages will continue to drive growth for manufactured homes.

One of our weakest performers in Consumer Discretionary was Mariott Vacations (VAC), a timeshare company, which we exited during the quarter. Although the company owns a large portfolio of attractive vacation properties, it missed revenue guidance due to slow sales, which were hurt by high borrowing rates and increasing defaults. In addition, the anticipated pent-up demand did not materialize.

A top performer in the Health Care sector was Natera Inc. (NTRA), a global leader in DNA testing with a focus on women's health, oncology, and organ health. The company performed well in the period, driven by strong third quarter results in their reproductive health division as well as their oncology testing business, which exceeded expectations and delivered one of its best quarters ever. Furthermore, the company also lowered its cash burn expectations, which investors viewed favorably. They plan to be cash flow neutral by the middle of 2024, which should expand the investor base.

A large detractor within Health Care was HealthEquity Inc. (HQY), which was a standout performer last quarter. The company operates like a bank — reinvesting the customer deposit float from corporate sponsored HSA plans into higher yielding, short-term financial products — so the Fed's recent pivot toward a more dovish stance threatens our "higher for longer" thesis and thus we decided to exit the position.

Turning to Industrials, our largest contributor both in the sector and the portfolio was Axon Enterprise (AXON), an integrated hardware and software company that develops technology products, such as the Taser, for law enforcement and the criminal justice system. Five out of its top ten deals in the quarter came from new contracts with the U.S. federal government, an important expansion from its traditional customer base of local and state law enforcement agencies. Total company future contracted revenue expected to be recognized over 10 years grew to $5.8 billion, signaling the long duration of Axon's business and cash flows. The company views itself as building the operating system for public safety and security. It has a goal of reducing fatalities in law enforcement by 50% within the next ten years, and Axon is still less than 20% penetrated in its core markets.

On the downside, our worst performing Industrial was KBR Inc. (KBR), a government and energy consulting firm. Despite reporting solid third quarter results, management reduced its 2025 earnings target due to a combination of higher interest rates and uncertainty around the rollout of its HomeSafe joint venture, a multi-billion-dollar exclusive contract to upgrade the relocation experience for all U.S. military personnel and their families. We trimmed the position to limit our downside risk but still believe the rollout of HomeSafe is more likely a question of "when" rather than "if."

Our greatest contributor in the Technology sector was DoubleVerify (DV), an ad verification company. DV rebounded nicely from a slowdown in revenue and EBITDA growth last quarter. Social media revenues grew significantly as customers increasingly leveraged DV's new short-form video verification tool across Meta reels, YouTube shorts, and TikTok. We are particularly excited about growth opportunities with Meta next year as DV is expected to expand coverage of Facebook's news feed. Likewise, social is only 16% of DV's total revenue vs 60% of digital ad spend for the industry, so this business can grow to multiples of the present size. Company revenues are growing 20%+ with 30%+ EBITDA margins.

Our largest detractor in Technology relative to the index was Clearwater Analytics (CWAN), a software company that provides investment accounting reporting. The stock languished due to several opportunistic stock sales during 2023 by its private equity holders. We are maintaining our position, as the company's fundamentals remain strong, with a technology advantage (single instance architecture, constantly updated software platform, and an aggressive new product roadmap) over competitors and 80% win rate. The company has a 20% growth rate target (with the potential to accelerate growth from pricing, products, and sales execution) with EBITDA margins guided to improve from 27% to 40% long term.

Portfolio Positioning & Outlook

As previously discussed, we felt that the post-pandemic business cycle was beginning to slow down, and that the next wave of market leadership was likely to come from innovative companies that could maintain a relative revenue growth advantage despite a slowing economy. The Fed's fourth quarter pivot reset investor expectations and improved sentiment, which propelled stocks across the board, including some of the lowest-quality small cap growth companies. We now believe that the Fed has sensed that an economic slowdown is an inevitable result of its aggressive rate hikes of last year and is thus trying to reverse course.

While an anticipated Fed rate stabilization or cut might also provide a nice tailwind to our portfolio, we believe that each of our positions has its own durable growth drivers. As always, we remain heavily invested in Technology, where AI is still top-of-mind and catalyzing a wave of advancement, as well as in Industrial stocks. In the same vein, we put cash to work in the lagging sectors of Health Care and Consumer (both Staples and Discretionary) during the fourth quarter, as valuations on both an absolute and relative basis looked attractive. We initiated positions in several fast-growing consumer stocks, including On Holding, Celsius Holdings, and e.l.f Beauty.

We also increased our allocation to medical device stocks (Shockwave, Transmedics, Insulet, and Axonics). As we discussed in our last letter, the entire sector had been adversely affected by a SELECT study involving GLP-1 drugs (e.g., Ozempic), which demonstrated an impressive 20% reduction in major cardiovascular events (heart attack, stroke, etc.). However, in early November, more details emerged about the study, revealing it was a bit less conclusive than first thought. Additionally, the North American cohort only saw an 8% reduction in cardiovascular events vs. 31% in Europe. All of these factors diminished the impact of the study and alleviated the downward pressure on the sector.

Times like these, when Fed policy is having as much impact on the market as company fundamentals, are a great reminder of why we are so consistent with our approach. Regardless of the macro environment, we are bottom-up investors, laser-focused on finding solid businesses that are well-positioned to capitalize on long-term secular growth trends. We believe these are the types of companies that should do well in most conditions, and we are loath to chase lower-quality companies even when the entire market is rallying. We continue to believe that most of the stocks in the Russell 2000 Growth Index do not meet our high standards for long-run revenue and earnings growth potential.

Please let us know if you have any questions as we begin the new year.

Regards,

Jim Callinan
Lead Portfolio Manager

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Performance prior to December 1, 2016 is that of another investment vehicle (the "Predecessor Fund") before the commencement of the Fund's operations. The Predecessor Fund was converted into the Fund on November 30, 2016. The Predecessor Fund's performance shown includes the deduction of the Predecessor Fund's actual operating expenses. In addition, the Predecessor Fund's performance shown has been recalculated using the management fee that applies to the Fund, which has the effect of reducing the Predecessor Fund's performance. The Predecessor Fund was not a registered mutual fund and so was not subject to the same operating expenses or investment and tax restrictions as the Fund. If it had been, the Predecessor Fund's performance may have been lower.

Mutual Fund investing involves risk. Principal loss is possible. The Osterweis Emerging Opportunity Fund may invest in unseasoned companies, which involve additional risks such as abrupt or erratic price movements. The Fund may invest in small and mid-sized companies, which may involve greater volatility than large-sized companies. The Fund may invest in IPOs and unseasoned companies that are in the early stages of their development and may pose more risk compared to more established companies. The Fund may invest in ETFs, which involve risks that do not apply to conventional funds. Higher turnover rates may result in increased transaction costs, which could impact performance. From time to time, the Fund may have concentrated positions in one or more sectors subjecting the Fund to sector emphasis risk. The Fund may invest in foreign and emerging market securities, which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks may increase for emerging markets.

The Russell 2000 Growth Index (Russell 2000G) is a market-capitalization-weighted index representing the small cap growth segment of U.S. equities. This index does not incur expenses, is not available for investment and includes the reinvestment of dividends.

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Complete holdings of all Osterweis mutual funds ("Funds") are generally available ten business days following quarter end. Holdings and sector allocations may change at any time due to ongoing portfolio management. Fund holdings as of the most recent quarter end are available here: Emerging Opportunity Fund

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The Osterweis Emerging Opportunity Fund's top 10 holdings may be viewed by clicking here.

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