Morningstar

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What the Future Holds

How the COVID-19 pandemic is reshaping the way we save, spend, and invest.

Young Fund, Old Hand
Jim Callinan continues his strong record at Osterweis.

UNDISCOVERED MANAGER

Laura Lallos

In every issue, Undiscovered Manager profiles a noteworthy strategy that hasn't yet been rated by Morningstar Research Services' manager research group.

When Jim Callinan headed west in 1996, he was right in time for the region's next big gold rush. And Callinan was poised to profit from it.

He was coming off a star turn at Putnam Investments in Boston, where he'd trained as an analyst before taking over Putnam OTC Emerging Growth Fund in 1994 and racking up a short but strong record. (The OTC fund floundered in later years, and Putnam merged it into another fund in 2008.) However, Callinan saw greater career potential with boutique firm Robertson Stephens, now RS Investments, which invited him to take over Robertson Stephens Emerging Growth.

"I joined Robertson Stephens because the firm was active in the technology space, both in terms of research and investment banking," he says, "but at the time it was not clear that San Francisco would become the center of the dot-com boom."

Callinan made the most of the opportunity, loading up on unloved Internet stocks in 1997 and early 1998. It was nice timing, and he then shifted successfully from consumer-based plays such as AOL into business-to-business names. That culminated in the fund posting a benchmark-crushing 183% return in 1999—stratospheric even by dot-com-boom standards—and Callinan being named Morningstar's Domestic Stock Manager of the Year. (The fund is now called Victory RS Small Cap Growth RSEGX.)

Callinan is still in San Francisco 20 years later. He and his wife, Letty—they met at Harvard Business School—raised four children in the area, and his youngest is at Stanford. Today, however, Callinan is based at Osterweis Capital Management.

He is at the helm of Osterweis Emerging Opportunity OSTGX, which opened in late 2016 shortly after Callinan joined the firm. As of Sept. 30, it has a three-year Morningstar Rating of 5 stars within the small-cap growth Morningstar Category. While the fund is not rated by Morningstar Research Services' fund analysts, it has earned a Morningstar Quantitative Rating of Bronze. (The Morningstar Quantitative Rating is designed to replicate the decision-making process used by Morningstar's analysts to rate funds that aren't on the analyst coverage list.)

While Osterweis Emerging Opportunity has lived up to Callinan's precedent of running starts, its strategy is not quite the same one that Callinan used in his early years at Putnam and Robertson Stephens. The evolution of his approach is part of the story of how Callinan came to Osterweis.

A Refined Strategy

Callinan initially built broadly diversified portfolios, upward of 100 stocks. That was partly to help mitigate the risk of investing in up-and-coming companies but also to accommodate burgeoning asset bases.

"When you are in the asset-gathering business," he says, "you get jaded because when you have a lot of money to run, you need to increase the number of names you invest in. As a consequence, you lower your knowledge of the companies. My first goal was to get great alpha from these positions, and I felt I couldn't do that running a 100-stock portfolio."

His investment strategy hinges on what he calls "anchor points"—achievable long-term growth targets. He offers as an example his early success with AOL. When Callinan first invested, the company had fewer than 100,000 subscribers, but CEO Steve Case was projecting 30 million. Callinan considered the goal achievable, given AOL's lack of competition. The stock was expensive in the near term, but in the long term, what Callinan calls "the anchor-point earnings potential" justified the price.

Today, Callinan maintains a concentrated portfolio to strictly focus on companies with solid anchor points. "There's a finite number of small-growth companies that can predict the future of their business out three to five years," he says. "You certainly can't get 100 of them. But 30 names aren't that hard to find."

Conversely, identifying anchor points is what emboldens Callinan to take a concentrated approach. "The concept allows us to have more confidence and higher conviction levels," he says.

Callinan initiated this strategy with an institutional separate account at RS Investments in 2006. However, a corporate restructuring led to changes that he feared would compromise his approach. He left in 2012, and took a limited partnership that was part of the separate account composite with him, enabling him to maintain his track record back to 2006.

"I wanted to have continuity of performance," he says, "so I quickly set up my own firm, Callinan Asset Management." He was open to advances from larger firms that could provide the support that would allow him to focus on investing. But he was also wary of "big asset-gathering firms like RS and Putnam."

Osterweis, a boutique firm with four other funds, struck the right balance. "It was a private partnership that I could plug into and avoid the rigmarole [of running my own company], and they were willing to start a mutual fund using my process," Callinan says.

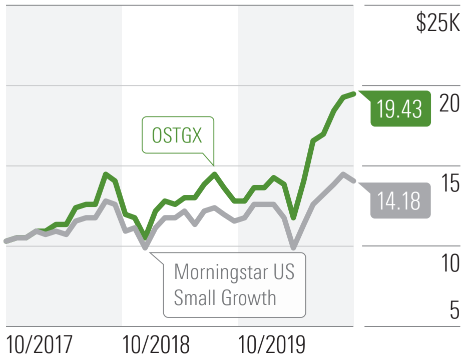
Osterweis Emerging Opportunity was launched with the conversion of the limited partnership he had run at RS and his own firm. (Morningstar marks the mutual fund's start date as the Nov. 30, 2016, conversion.) The limited partnership included his own substantial investment, and Callinan is still a significant shareholder in the fund; according to the June statement of additional information, his stake represents 36% of assets under management.

That stake piqued the interest of advisor Jeff Platt, founder and CIO of Platt Wealth Management in San Diego. Platt uses a mix of index and active funds, focusing particularly on active managers in areas where he believes they can add the most value, such as international and small-cap stocks.

Jim Callinan, chief investment officer, emerging growth, at Osterweis Capital Management.

Osterweis Emerging Opportunity OSTGX

Growth of $10K



Morningstar Category	Small Growth
Morningstar Rating	★★★★★
Expense Ratio (%)	1.16

Source: Morningstar Direct. Data as of 09/30/2020.

Platt says he normally doesn't invest in funds with less than $100 million in assets, but he made an exception for Osterweis Emerging Opportunity, first investing when the fund was well under that mark. "I remembered Jim Callinan from RS," Platt says. "Given his own investment, I know he's going to be conscientious and do what's best for my clients."

Advisor Tim McFadden placed clients in the fund almost as soon as it opened—and he personally invests in it, too. McFadden, founding partner of TJT Capital Group in Stamford, Connecticut, was comfortable getting on board early because he had invested with Callinan since the Putnam days. "He's done a very good job over the years," he says. "I used Putnam OTC and then the company I was working for helped seed a few of the Robertson Stephens funds. If a good portfolio manager goes elsewhere, we stay in touch and take a look at the new opportunity."

Stock by Stock

While leaving a large firm for a smaller one can increase opportunity and independence, it can also mean the loss of extensive research resources. At Osterweis, Callinan has carved out a small team dedicated to his approach and they are building a track record together. Analyst Matt Unger was an analyst at RS Investments before joining Callinan at Osterweis in 2016. Bryan Wong was part of the Osterweis core equity group when Callinan arrived, but his growth orientation made him a better fit for the emerging growth strategy, and he moved over in 2017.

"Matt's first recommendation was Trex TREX, so he hit the ground running," laughs Callinan. Trex was one of the fund's earliest picks. "The company had all the things most growth investors look for, and then we layered on the anchor-point potential. At the time, they were aiming for a 50% share of the composite decking market. Looking forward, we think composites like Trex can become a third of the total decking market." The stock surged this year on the wave of outdoor home improvement projects sparked by the pandemic.

Unger focuses on industrials and healthcare, while Wong's expertise is in technology and software. Callinan credits Wong with Fiverr International FVRR, another home run for the fund so far this year. The digital-services marketplace "probably got a four-year jump-start to their business now that people are working from home. Revenue growth accelerated from 44% in the first quarter to 82% in the second. That's a great dynamic, but that went into the stock price."

Callinan uses a valuation overlay that led him to sell Trex and cut back on Fiverr this year. "We have a very disciplined valuation approach layered on to the concentrated portfolio so that when we do get a move in a stock, we don't hold on to it too long. We trim and then eliminate the name when the anchor-point potential is fully realized."

When valuations are inflated and volatility is high, Callinan is willing to raise cash—in late August, his stake was on the high end, at 15%. That allows him take advantage of buying opportunities.

Enphase Energy ENPH has been one such opportunity, as other investors dumped the stock: "The company has great margins, but 'the world's coming to an end, who's going to buy a solar system?'"

Looking ahead, Callinan sees solar as a "monster category." He expects states to continue to subsidize the technology and younger consumers to increasingly demand it—and he believes Enphase is the best way to play it because of its superior storage system.

Biotech is another area Callinan is enthusiastic about; he says that while the Russell 2000 Growth Index is rife with tiny, unprofitable biotech names, it is an area worth sifting through. He singles out Iovance Biotherapeutics IOVA, which develops cancer immunotherapy products. "We think we will get paid. Either the company will grow and get great license deals, or they'll sell to companies like Merck MRK and Pfizer PFE."

Wrangling Risk

The fund is up 42.8% for the year to date through September, more than 30 percentage points ahead of the category average. It's worth noting that its average market cap has been in line with the category norm—in other words, returns weren't juiced with the large-cap growth names that have dominated the market. Morningstar Direct's performance attribution analysis credits the strong showing to strong stock picks in most sectors.

Busts often follow booms, of course, as with Callinan's dramatic early success at RS Investments, which was followed by precipitous losses in the dot-com crash. Prospective investors should note that Osterweis Emerging Growth's 5-star rating reflects high returns relative to the small-growth category over the past three years but also high risk.

"It's a concentrated fund, so it will be occasionally out of sync," Platt says. "But over time, that style has led to outperformance." Success with a strategy like this is a question of being aware of the risk and able to ride it out.

As McFadden puts it, "This outperformance is tremendous—but we understand how aggressive Callinan is." He also cautions that the fund is best used in tax-deferred accounts because of its high turnover.

The Osterweis Small Cap Growth Composite separate account (which has a nearly identical portfolio) reflects the performance of Callinan's concentrated approach back to its beginnings in 2006. This record isn't a perfect proxy for how the mutual fund would have performed before its inception—there are key differences such as expenses and research resources. That said, it is worth noting that while volatility has been a constant for the composite over time, so have strong returns. Over the past decade, the composite's three-year rolling returns beat both the Russell 1000 Growth Index and the small-growth category about 95% of the time.

The approach is not designed to manage volatility per se, but there are some checks built into the system. The maximum position size is generally 5%; that and the valuation overlay lead Callinan to trim names heading for the stratosphere, and the cash stake that sometimes results can provide a bit of cushion. Sector stakes won't exceed 1.5 times the Russell 2000 Growth weights; while that leaves plenty of leeway to load up on technology and healthcare, the fund's stakes aren't outsize relative to its category peers.

Callinan aims for a different kind of diversification, offsetting higher-risk growth prospects with more stable names. Only about one third of the portfolio is invested in "undiscovered or misunderstood" companies that promise greater than 30% revenue growth annually. One such firm is Kornit Digital KRNT, which manufactures textile printers; it's listed in the U.S. but headquartered in Israel. "It's a great little story, but it's unknown," Callinan says.

Aggressive picks such as that are offset by similar allocations to two other categories. "Breakthrough" companies are ramping up profitability and establishing themselves as leaders, while growing revenue 2% to 40% annually—such as Alteryx AYX, which provides popular data analysis software.

The third category provides more ballast—stable "proven" companies with 15% to 25% revenue growth. Etsy ETSY is a good example. The pandemic has sparked a great run for the stock, fueled by sales of reusable masks, but the stalwart has been in the portfolio since 2017. Callinan says its business model gives Etsy its edge: "It's a two-sided marketplace, with really passionate sellers and a customer base that's extremely loyal."

Sticking With It

The fund's strong performance so far has not attracted an onslaught of attention. "I am somewhat surprised that the fund has not taken in more assets," McFadden says. "Of course, if it grows too big, that may have an effect on performance, but at this size the fund still has plenty of room to grow."

Callinan is well aware of the danger posed by asset growth. He's set the strategy's capacity at around $1.5 billion because he does not want to broaden the portfolio or expand too far into mid-cap territory. With less than $300 million today between the fund and the separately managed accounts, capacity is not a concern. Despite its small size, the fund has a 1.16% expense ratio—not a bargain but in line with the norm for its category.

"Our advantage is that we've always looked at undiscovered, new-to-the-market companies that are mysterious to most investors," Callinan says, and he wants to guard that edge. He notes, for example, that IPOs are on the rise again, which promises a pool of opportunities after the initial excitement wears off. "The stocks will correct, and then we'll have a huge pool of undervalued small-growth stocks."

Callinan is settled in, doing what he loves, at a firm that respects his process. When pressed for information on hobbies and other outside interests, he mentions reading, working out, and skiing with his family—but the conversation always comes back to stock-picking.

"I don't really have that exciting a life outside of investing," he insists. This emerging-growth portfolio is perhaps excitement enough. M

Laura Lallos is managing editor of *Morningstar* magazine.

Photography by David Lees.

OSTERWEIS EMERGING OPPORTUNITY FUND

Morningstar Magazine

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The Fund's average annual total return for the one year, three year, five year, ten year, and since-inception periods ending 3/31/2023 were as follows:

	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Since Inception (10/1/2012)
Osterweis Emerging Opportunity Fund	*-10.18%*	*17.67%*	*10.84%*	*13.61%*	*13.60%*
Russell 2000 Growth Index	*-10.60%*	*13.36%*	*4.26%*	*8.49%*	*9.38%*
Morningstar Small Cap Growth Category Average	*-12.05%*	*16.23%*	*7.27%*	*9.58%*	*N/A*

Gross/Net expense ratio as of 3/31/2022: 1.17% / 1.10%. The Adviser has contractually agreed to waive certain fees through June 30, 2023. The net expense ratio is applicable to investors.

Performance data quoted represents past performance and 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 lower or higher than the performance quoted above. *Performance data current to the most recent month end may be obtained by calling toll-free (866) 236-0050.*

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.

Opinions expressed in the article are those of the author and portfolio manager. These opinions are subject to change at any time, are not guaranteed and should not be considered investment advice.

The Osterweis Funds are available by prospectus only. The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The summary and statutory prospectuses contain this and other important information about the Funds. You may obtain a summary or statutory prospectus by calling toll free at (866) 236-0050, or visiting www.osterweis.com/statpro. Please read the prospectus carefully before investing to ensure the Fund is appropriate for your goals and risk tolerance.

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

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security. Top ten holdings as of 3/31/2023 can be viewed here: OSTGX Holdings.

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.

Morningstar Managers of the Year are determined by a combination of qualitative research by Morningstar's manager research analysts; risk-adjusted medium- to long-term performance track records; and performance in the calendar year.

The Fund was rated by Morningstar 4 Stars against 576 funds Overall, 3 Stars against 576 funds over 3 Years, 4 Stars against 534 funds over 5 Years in the Small Growth category based on risk-adjusted returns as of 3/31/2023.

The Morningstar Rating™ for funds, or "star rating," is calculated for mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period has the greatest impact because it is included in all three rating periods. The Osterweis Emerging Opportunity Fund does not have a five-year Morningstar rating at this time.

While the fund is no-load, management fees and other expenses still apply. Please refer to the prospectus for more information.

Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales.

Alpha is a measure of the difference between the portfolio's actual return versus its expected performance, given its level of risk as measured by Beta. It is a measure of the historical movement of a portfolio's performance not explained by movements of the market. It is also referred to as a portfolio's non-systematic return.

Earnings growth is not representative of the Fund's future performance.

EBITDA is an acronym for Earnings Before Interest, Taxes, Depreciation and Amortization.

Earnings Per Share (EPS) is a company's earnings per outstanding share of common stock.

Price-to-Earnings (P/E) Ratio is the ratio of a company's stock price to its twelve months' earnings per share.

It is not possible to directly invest in an index.

Diversification does not guarantee a profit or protect from loss in a declining market.

Osterweis Capital Management is the adviser to the Osterweis Funds, which are distributed by Quasar Distributors, LLC. [OSTE-20211203-0383]