CITYWIRE

After nearly 20 years on his Driehaus Micro Cap Growth strategy, Jeff James has built a reputation for picking winning stocks. He reveals what's on his radar today

VICKY GE HUANG

At a recent lunch in Chicago, fund selector Paul Courtney explained that he only picks underperforming managers. While it may sound counterintuitive, Courtney actually has plenty of method and not much madness.

'We typically only invest in managers that have good long-term track records, but have struggled relative to their benchmark in the recent past. Mean reversion of excess returns is a powerful and underappreciated factor in investing,' he says.

Courtney, director of research at SpringTide Partners, looks for funds where the firm, team and philosophy have not changed, but where total returns have lagged the benchmark in the short term. He argues that this is likely to be just a blip, often down to the manager's preferred approach being out of favor. The fund is more likely to outperform going forward, he suggests.

There have been a number of academic studies to support Courtney's approach too. One recent paper co-authored by Jason Hsu, CIO at Rayliant Global Advisors and vice chairman at Research Affiliates, found that funds that had outperformed on a three-year basis typically went on to lag their peer group, while those that had previously posted below-average numbers during this period were more likely to beat their rivals in the future.

But as with every good rule, there are some exceptions. 'There are very few exceptions to this rule, but Jeff James is one of them,' Courtney says. 'Despite having outperformed for all but one of the past 17 years, Jeff remains really humble. He also knows his portfolio companies exceptionally well.' High praise indeed.

Citywire AA-rated James runs the $295 million Driehaus Micro Cap Growth fund. It has only been available as a mutual fund in its current iteration since November 2013, and over three years to the end of July it has returned 55.8%, beating all of its Citywire-tracked Small-Cap Growth peers. On a risk-adjusted basis, James also tops the peer group with a manager ratio of 1.22 – well ahead of the next best at 0.97.

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James has run the strategy since January 1998 and since then has returned an average of 20.66% each year, versus the Russell 2000 Growth's 6.85%.

He was joined on the strategy by co-manager Michael Buck in early 2009.

BREAKING THE MOLD

So what is behind James's exceptional numbers? He credits his outperformance to his ability to find less familiar firms, allowing him to run a differentiated portfolio compared to his peers.

'I could go through the whole portfolio and many of the companies would not be the usual names that investors would have heard of,' he says. 'It's a lot of work but it's a very fun process.'

Whether unknown or more familiar, all firms in James's fund must be innovative, well-managed, gaining market share and growing their revenues, margins and earnings on a sustained basis.

'We're constantly looking for new ideas and... [firms with] the right characteristics that will drive the stock earnings,' he says.

As a growth investor, he uses a blend of bottom-up analysis and top-down techniques to find these firms.

Of the 27 years he has spent in the industry, 20 have been with Chicago-based Driehaus Capital Management.

The $8.9 billion boutique was founded in 1982 by renowned investor Richard H. Driehaus, whose growth approach to investing appealed to James, then an MBA student at DePaul University.

James says that his and Driehaus's philosophies and approaches have remained remarkably consistent over his two decades with the firm and running the strategy.

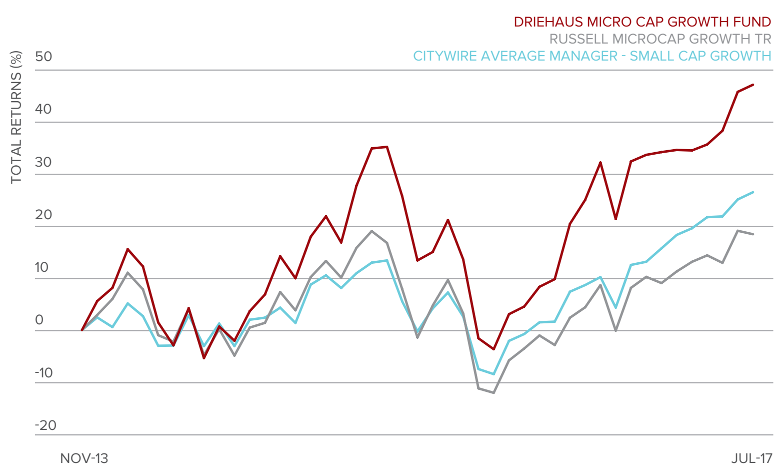
'We believe our purchases are based on the market truism that earnings, growth and earnings revisions are the characteristics that drive the stock growth of our time,' he says.

He applies the same focus on fundamentals when it comes to cutting holdings too.

'We let the fundamental trends dictate when we want to begin trimming or exiting the stock,' he says. 'We also look at the thematic [trends], sector and market, the bottom-up part of the analysis as well as how the stock is performing.

JAMES'S DRIEHAUS FUND HAS PULLED AWAY FROM ITS BENCHMARK

SOURCE: CITYWIRE/LIPPER



We generally let our winners run – we have no specific cut-off in terms of when we exit a stock.'

BACKING THE RIGHT HORSE

And James has had plenty of winners over the years. In the most recent quarter, he attributed his strong numbers to solid earnings across the strategy, particularly in the healthcare and technology sectors.

Within healthcare, medical devices and biotech have been two of the best performing industries.

He names Tactile Systems Technology as one example. He bought the stock at $11 per share in July 2016 and it now trades at a $32 per share.

'They sell medical products that treat lymphedema. It's a condition that has very few effective treatments,' he says.

'The company's direct selling model to patients bypasses distributors and that has allowed it to gain market share, grow much more rapidly, gain other solutions and induce much higher-than-average margins, while still growing their business in terms of new products and sales reps.'

Another high-flying stock James bought last year was email security firm Mimecast. Having bought in at $16 per share, James is pleased to see the stock now trading at $27 per share, with a market cap of $1.5 billion.

'The email security market is a $10 billion market that's growing rapidly, as enterprises need to address security from multiple angles,' he says. 'We think recent threats such as Ransomware remind us that hacking and threats to enterprises are a continual problem for them.'

'We think Mimecast's revenue growth, new business wins and continued acceleration have been evident in the last few quarters. They are benefiting from an upgrade cycle in Microsoft Office and general awareness of the strong security spending market.'

While growth managers have outperformed their value counterparts in 2017, small caps have lagged their large cap peers.

With the so-called Trump bump appearing to fade as priced-in promises fail to materialize, some investors have suggested possible tax reform may yet reinvigorate the rally, particularly for more domestically-focused small caps.

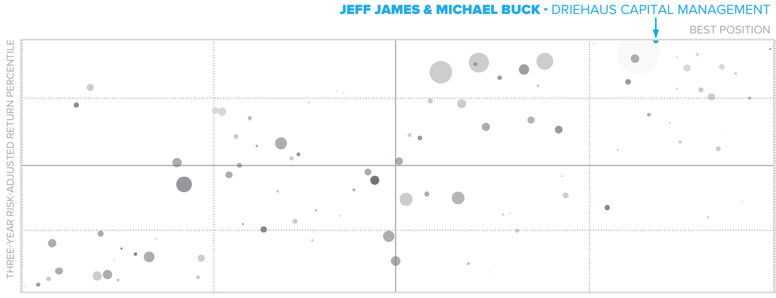
James is not one of them.

'We have a low degree of confidence in tax reform, so our thesis is not based on [small and micro-caps] getting [a] large percentage of tax cuts,' he says. 'We own all the stocks we own because of stock-specific characteristics.'

With their comparative track record, James's stock-picking skills look a safer bet than Trump's tax policies. ■

JAMES'S RISK-ADJUSTED POSITION IS SECTOR-LEADING

SOURCE: CITYWIRE DISCOVERY



The vertical axis shows three-year risk-adjusted return percentile, the horizontal shows one-year risk-adjusted return percentile. The size of the bubbles shows manager market share. Analysis at July 31 2017. For more details, contact discovery@citywireinsight.com

VERDICT

FRANK TALBOT
HEAD OF INVESTMENT RESEARCH, CITYWIRE

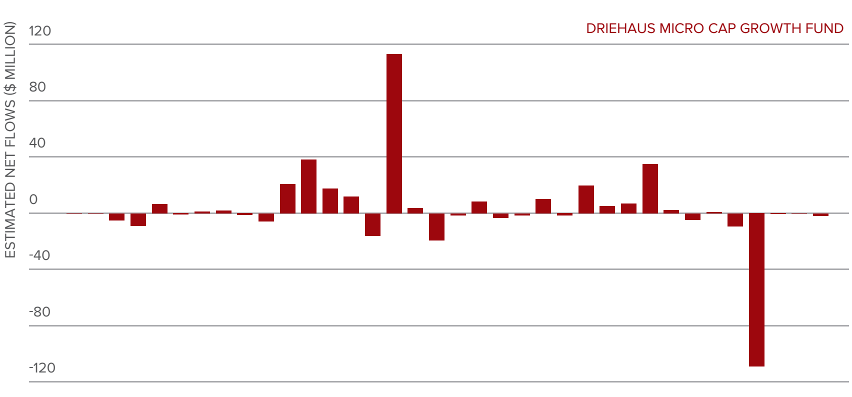
James has done an impressive job on this portfolio, proving he can replicate performance over the long term and through the transition to a 40 Act structure. He has done it all while taking on slightly more risk than the index, but not to a startling degree, with a beta of 1.1.

The portfolio is currently overweight small caps, with around half the fund in issues with a market cap of more than $1 billion. This might be due to the manager's penchant for running with winners, or it could be to balance out the volatility and risk in the micro-cap space.

What I find most surprising about James's fund is that despite the exceptional returns – it has the best risk-adjusted numbers in the peer group over three years – the money just isn't following. Whether this is down to a lack of marketing clout or investors' inertia is not clear, but either way the latter are missing out.

THE FUND HAS BEEN HIT BY THE WIDER TREND OF OUTFLOWS FROM SMALL-CAP EQUITY

SOURCE: LIPPER



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Month-end Performance (%) as of 8/31/17

	MTH	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception (1/1/03)[3]
Driehaus Micro Cap Growth Fund[1]	**1.44**	**11.70**	**19.44**	**14.09**	**18.82**	**9.49**	**16.99**
Russell Microcap® Growth Index[2]	0.80	8.33	14.42	6.04	12.67	6.08	9.49

Calendar Quarter-end Performance (%) as of 6/30/17

	QTR	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception (1/1/03)[3]
Driehaus Micro Cap Growth Fund[1]	**8.41**	**9.09**	**32.95**	**11.90**	**19.80**	**9.04**	**17.02**
Russell Microcap® Growth Index[2]	5.29	8.07	22.71	4.61	12.76	5.57	9.59

Annual Fund Operating Expenses (%)*

Driehaus Micro Cap Growth Fund	
Management Fee	1.25
Other Expenses	0.23
Total Annual Fund Operating Expenses	**1.48**

*Represents the estimated Annual Fund Operating Expenses as disclosed in the current prospectus dated April 30, 2017. It is important to understand that a decline in the Fund's average net assets due to unprecedented market volatility or other factors could cause the Fund's expense ratio for the current fiscal year to be higher than the expense information presented. "Other Expenses" are estimated for the current fiscal year.

[1]The average annual total returns of the Driehaus Micro Cap Growth Fund include the performance of one of the Fund's predecessor limited partnerships, which is calculated from January 1, 2003, before the Fund commenced operations and succeeded to the assets of its predecessors on November 18, 2013. The Fund's predecessors are the Driehaus Micro Cap Fund, L.P. (1996 inception) and the Driehaus Institutional Micro Cap Fund, L.P. (2011 inception). The performance of the Driehaus Micro Cap Fund, L.P., which was selected because it has the longer track record of the two predecessor partnerships, has been restated to reflect estimated expenses of the Fund. The predecessor limited partnerships were not registered under the Investment Company Act of 1940, as amended ("1940 Act") and thus were not subject to certain investment and operational restrictions that are imposed by the 1940 Act. If the predecessors had been registered under the 1940 Act, their performance may have been adversely affected. After-tax performance returns are not included for the Driehaus Micro Cap Fund, L.P. The predecessors were not regulated investment companies and therefore did not distribute current or accumulated earnings. [2]The Russell Microcap® Growth Index is constructed to provide a comprehensive and unbiased barometer of the microcap growth market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine growth probability approximates the aggregate microcap growth manager's opportunity set. The index has an inception date of July 2000.[3]"Since Inception" is calculated to include performance from the Fund's predecessor limited partnership (Performance Inception Date: 1/1/2003).

At times, a significant portion of a Fund's return may be attributable to investments in initial public offerings (IPOs) or concentrations in certain strong performing sectors, such as technology. Returns from IPOs or sector concentrations may not be repeated or consistently achieved in the future. In addition, participating in IPOs and other investments during favorable market conditions may enhance the performance of a Fund with a smaller asset base, and this Fund may not experience similar performance results as its assets grow. The securities of micro-cap companies may be more volatile in price, have wider spreads between their bid and ask prices, and have significantly lower trading volumes than the securities of larger capitalization companies. As a result, the purchase and sale of more than a limited number of shares of the securities of a smaller company may affect its market price. Growth stocks may involve special risks and their prices may be more volatile than the overall market. It is anticipated that the Fund will experience high rates of portfolio turnover, which may result in payment by the Fund of above-average transaction costs. These and other risk considerations are discussed in the Fund's prospectus. **Please consider the investment objectives, risks, fees and expenses of the Fund carefully prior to investing. The prospectus and summary prospectus contain this and other important information about the Fund. To obtain a copy of the prospectus and/or summary prospectus, please call us at (800) 560-6111 or visit www.driehaus.com. Please read the prospectus carefully before investing.**

Sources: Driehaus Capital Management LLC, Russell Investments, SS&C Inc.

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