LISANTI CAPITAL GROWTH

From Deflation to Reflation?

Highlights

Investors have been conditioned to be wary of inflation and its asset-destroying force. However, there is another side to this tale: the return of pricing power. At Lisanti Capital, we believe that one very important result of reflation would be the ability of certain companies to raise and, importantly, stick to, higher prices. Two critical trends are driving these price increases: limited capacity and increased demand.

Our analysis shows that the ability to raise prices cannot be accessed by all companies. In fact, only those selective companies located at the juncture of these two trends will benefit. Our research process has identified not only the trends, but also those companies most likely to successfully increase price resulting in improved, above expectations levels of profitability.

The Great Debate

One of the great debates raging in the investment community currently is "Will inflation return?" and if so, what are the implications and impacts?

Some investors tend to focus on the more traditional aspects of the impact of inflation including rising interest rates and the intention of the FOMC to raise rates to "normalize" rate levels. We believe there is another impact of reflation that investors may be overlooking: the ability of producers and distributors to raise prices.

It has been decades since we have seen the ability to raise prices across many sectors of the U.S. economy. In fact, the opposite has been true, as many parts of the Industrial, Technology and Consumer sectors have struggled with overseas competition which has arrived in the U.S. in the form of lower prices and the inability of producers and distributors to raise prices. Additional price pressure has resulted from the dislocations of technological innovation (such as the Internet).

Over the past few years, in particular, investors have heard many companies discuss the costly headwinds they face including: the impacts of:

- Rising wages
- Component inflation
- Increased regulation

Some companies have been able to offset some of these costs with increased operational efficiencies and in the process, becoming leaner and meaner, however, the headwinds have been tough to combat.

The World is Changing

It seems to us that certain critical factors may be moving into position to allow companies to begin to see some of the positive aspects of reflation, namely, the ability to raise prices and stick to those higher prices. To those of us conditioned to years of declining prices, as a result of deflationary pressures, this might seem incomprehensible. How can companies begin to raise prices? We believe it is the result of several disparate factors moving into the economic framework concurrently.

The first factor: CAPACITY. Tight capacity in a specific industry or sector may be a key driver of the ability to raise price.
--Anecdotally, we have heard about tight capacity in many Industrial sectors, such as transportation and metalworking, where companies have been slow to add capacity or have found it difficult to do so due to the shortage of skilled labor.
-- We have also seen intentional capacity reductions in certain consumer sectors. For example, restaurants and retailers have been closing stores in response to the rise of the online shopping, specifically through Amazon.
--We have also seen areas of the Technology sector that have been slow to add capacity, such as semiconductors, where four foundry companies control most of the production and lead times for delivery of equipment can be as long as a four-year wait.

The second factor relates to demand, obviously INCREASED DEMAND. We see early signs of increased demand in certain sectors, as the economy (as measured by GDP) chugs along at around a 2% annual rate. Some of the secular changes occurring in the economy add growth. For instance, as more people buy through Amazon, Amazon in turn ships more packages. Amazon's increased activity drives increased usage in the transportation sector as more packages move through the transportation system. This increased activity increases demand in that sector. Additionally, as transportation companies seek increased operating efficiencies using technology, we see increased demand for the semiconductor components that will power that effort.

Another potential driver of increased demand is recent passage of the new U.S. tax plan. Taking a look back at the impact of the last tax cut in the U.S. in the late 1980s, consumers responded with an increase in restaurant and retail traffic. While we have not yet seen a significant change in consumer behavior following the recent tax cut, we hear anecdotal signs that this same change in consumer behavior may be developing.

INSIGHTS:THE ULTIMATE OUTCOME:
IT'S ABOUT PRICING POWER—
PRICE INCREASES DRIVE IMPROVED PROFITS

It is the COMBINATION of those two trends – reduced capacity and increased demand -that creates a backdrop against which companies can consider price increases. In our view, only those companies with products or services that are in the sweet spot of these two trends will be able to successfully increase and adhere to increased prices. Indeed, our research has uncovered that selective companies in the Industrial space, in the Semiconductor sector, and even in the Consumer sector are beginning to stake their claims to price increases—and this group may increase as increased tariffs take hold and companies seek to pass on some of those increased costs to end customers.

While we believe that the changes in the global economy and the global competitive environment will not allow for the "runaway inflation" that was so destructive to capital assets in the late 1970s/early 1980s, we do believe that we might be entering an environment that would allow for some selective pricing power, or reflation. Were companies able to raise prices, say 2-3% annually, we believe it could have a disproportionately positive impact on profit margins. Our observation has been that the vast majority of price increases tend to fall through to the bottom line.

If we are correct in our observations that we are at the beginning of a cycle of pricing power for select American industries, particularly smaller and mid-sized companies, then certain companies could also be at the beginning of a cycle of rising and above expectations levels of profitability. The ability to increase price is definitely not applicable to all small- and mid-sized companies; rather, this trend will only benefit a highly selective group of companies – those that can take advantage of their strategic positioning as evidenced by limited capacity and increased demand.

The ability to discern the trends and more importantly, the specific winners and losers in this emerging economic framework, we believe, will require experience and judgement that only active managers can provide.

LISANTI CAPITAL GROWTH
Investing in growth

About Us

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About Lisanti Capital Growth:
Lisanti Capital Growth, LLC (Lisanti), founded by Mary Lisanti, is a certified woman-owned and managed SEC registered investment advisor specializing in U.S. small- and small/mid-cap (SMID) equity growth investing. In September 2017, Dinosaur Group Holdings, LLC, the parent company of DCM Advisors, LLC (DCM), an affiliated registered investment advisor, acquired a minority interest in Lisanti. Lisanti manages separately managed accounts and is the investment adviser to the Lisanti Small Cap Growth Fund (ASCGX). DCM is an SEC registered investment advisory firm providing asset management and wealth advisory services to institutions, registered investment advisors, family offices and high net worth individuals.

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** Years of experience*

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Past performance is not indicative of future results. Investments in small companies carry greater risk than is customarily associated with larger companies for various reasons such as narrower markets, limited financial resources and less liquid stock. Investments in technology companies are vulnerable to factors affecting that sector, such as dependency on consumer and business acceptance as new technology evolves. The Industrial sector can be significantly affected by business cycle fluctuations, worldwide economy growth, government and corporate spending and others.

The views expressed reflect those of the portfolio manager as of the date noted. The portfolio manager's views are subject to change at any time based on market and other various conditions.

Before investing, you should carefully consider the Lisanti Small Cap Growth Fund's investment objectives, risks, charges, and expenses. This and other information is in the prospectus, a copy of which may be obtained by calling (800) 441-7031. Please read the prospects carefully before you invest.

Foreside Fund Services, LLC is the distributor for the Lisanti Small Cap Growth Fund.

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