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Episode 11

Third Quarter 2014 Review of the Small Cap Quality Value Portfolio

Craig Stone
Portfolio Manager & Senior Research Analyst

Hello, this is Craig Stone, co-Portfolio Manager of the Kayne Anderson Rudnick Small Cap Quality Value Portfolio. Today, I would like to offer some comments regarding the equity markets, our Q3 2014 portfolio performance, and briefly discuss, CARBO Ceramics, one of our underperforming investments in the quarter.

It was generally an interesting third quarter for the equity market, as the Russell 2000 Value Index gyrated between negative and positive monthly returns. July saw the Russell 2000 Value Index down just over 6% for the month, followed by a recovery in August up 4.35%, and ended the quarter with the month of September down 6.75%. Cumulatively for the third quarter, the Russell 2000 Value Index ended down 8.6%. And through the first 15 days of October, the Russell 2000 Value Index is down another 2.6% month-to-date.

We have been saying in our market commentary since the beginning of this year that a minor market correction is overdue, is healthy, and is a natural part in investing, particularly after the multiple years of exceptional returns that we have seen over the last couple of years, but we do not believe that this market correction is like that of the meltdown that we saw back in 2008 and 2009.

So how did our portfolio do in the third quarter with all of this monthly equity market volatility? For those of you who are familiar with our firm and have been clients of ours through a full economic cycle, you certainly know that our high-quality investment philosophy has a certain investment return pattern. To further elaborate, we say that typically during the course of a full economic cycle, our investors should expect our portfolios to have good capital protection during tough economic times, and we try to keep up with buoyant market recovery periods.

While this performance pattern is more evident over longer time frames, we saw evidence of this during each of the past three months in the third quarter. In July, as the Russell 2000 Value Index declined, we saw good capital protection in our portfolio and outperformed by about 100 basis points. And as the index recovered strongly in August, our portfolio lagged by 60 basis points, but as the European economic worries spilled into the U.S. equity markets and drove the benchmark lower in September, our investment model once again protected capital well and outperformed by nearly 300 basis points in a sharp declining market.

So, putting it all together, for the quarter, we saw our Small Cap Quality Value Portfolio outperform by nearly 330 basis points. This was a good accomplishment despite one of our stocks, CARBO Ceramics, seeing significant performance detraction during the quarter. This, along with the Real Estate Investment Trust sector, or REITs as commonly referred, continued to outperform the overall benchmark in the quarter.

Today, REIT stocks as a group is the largest single industry in the benchmark and represents 14.5% of the entire Russell 2000 Value Index. With the 10-year Treasury rate declining year to date to the current 2% yield level—this is after starting out the year at the 3% level—REIT stocks, with their higher dividend yield than the typical average stocks, have garnered increasing attention of average investors seeking yield enhancement to their portfolios.

When we break down the Russell 2000 Value and its individual stock components, we see that so far in 2014, through the end of third quarter, stocks with dividend yields of higher than 3% have seen positive returns while stocks in the benchmark with less than 3% yield saw negative returns. This is quite the contrast, and REITs certainly played an important part in this bifurcation of returns. In fact, when we look at REIT stocks as an asset category of the Russell 2000 Value, for the same 9-month period thus far in 2014, REITs have had a positive return of 8.5% versus the overall benchmark that posted a negative 4.7% return. This delta of 1300 basis points is significant for any time period, especially such a short period that we just witnessed.

While we do not currently own any REITS in our portfolio, and have only owned a few names in the past, the under-representation of REITs in our portfolio is more structural than just valuation. With our quality investment philosophy, we typically favor a distinctive high return on capital businesses that is asset light in nature and that can generate above-industry return while needing little debt on the balance sheet to generate that high return. In the two decades that we have been managing small-cap portfolios, we find that REITs in general have indistinguishable business models that require large levels of debt or equity capital to generate—even at the best of times for the best company in the industry —only near a 15% return on equity. This is very much the opposite of what we consider high-quality businesses, and because we can find plenty of other businesses that can meet our quality hurdle, we have always had an under-representation of REIT stocks in our portfolio. Now, to be fair, there are plenty of other periods where our underweight of REITs has benefitted our portfolio, but right now it is a headwind for us. But then, even with this strong headwind, we have been able to overcome some of this near term through our superior stock selection.

At this time, I would also like to offer a brief insight into one of our holdings, CARBO Ceramics (ticker: CRR). Typically, given our strong performance in the quarter, I would not normally want to spend so much time on a single underperforming stock, but given that the stock has been such an outlier in the quarter, I thought some comments and perspective would be helpful.

We have owned CARBO in the portfolio since 2009, and at the firm for a much longer period than that, but since 2009, we have increased and trimmed CARBO positions multiple times, with our last trim of the stock being this past July. But subsequent to our trim, CARBO saw its stock decline sharply during the quarter for both fundamental and cyclical reasons. For those of you who are not familiar with CARBO, this is a company that manufactures and sells ceramic proppants that are used during the hydraulic fracturing process of oil and gas well production. Ceramics has been proven to have higher conductivity and better recovery rates than the most commonly used proppant, being sand. However, ceramic proppants have a much higher selling price, and E&P operators are constantly experimenting with the mix of sand and use of ceramics proppants. Depending on geology and the need to lower production costs, E&P operators many times will choose sand over ceramics.

In early August, CARBO's stock took a hit after one of its largest customers decided to switch entirely to sand from a mixture of sand and ceramic proppants after comparing well performances over a three to four-year period. This switch likely will have a per well savings of nearly half of a million dollars for the customer. CARBO, up to this point, who had been capacity constrained and had planned on new capacity addition coming on next year, initially stated that it would have other customers that would be willing and able to absorb the capacity in other regions. However, disappointingly, about a month later, CARBO pre-announced, stating that the coming quarter sales volume was still going to be below the initial replacement expectations that it has cited, and that in fact the pricing for ceramics will likely come under pressure as well. All of this proved to be bad for the stock price.

But at the end of the day, when we look back on our investment in CARBO Ceramics, while the performance of this quarter hurt, we still saw significant outperformance in the quarter for our overall portfolio. Furthermore, assessing CARBO's stock performance since our initial purchase in 2009, and taking into account the position size adjustments that we made through our adds and trims, this stock did generate a very positive cumulative return for the entire period that we owned the stock in the portfolio.

Do we wish that we trimmed more or even sold our entire position when we acted in July? Sure, but hindsight is always perfect, and this is why no one should be driving using the rearview mirror.

In summary, our capital protection in a tough market environment shone brightly this quarter. Even with CARBO Ceramics and the REIT headwind, we were able to overcome and outperform significantly. This is a true testament to our high-quality focus and our ability to own a focused portfolio of great businesses.

Thank you for taking the time to listen to this recording today, and as always, if there are questions or comments, please feel free to reach out to your representative contact.