KayneCast

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Episode 17

International Small Cap Portfolio

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Hello, this is Craig Thrasher. I'm a portfolio manager at Kayne Anderson Rudnick, and I'm here to discuss our International Small Cap strategy. I'm going to talk a little bit about why we think the international small-cap space is an attractive asset class generally speaking, and also why we're excited about the prospects for our International Small Cap strategy here at Kayne Anderson.

So, first, discussing the asset class as an investor, what I find most compelling about the international small-cap asset class is that it's a relatively inefficient market. And probably the best way to demonstrate this inefficiency is to compare and contrast international small cap with the domestic equity markets, which I believe most U.S. investors are more familiar with.

Starting with the large-cap market in the U.S., we could use the S&P 500 as a good proxy. The S&P 500 has approximately 500 companies in it with an average market cap of around $38 billion, and these 500 companies on average have about 20 analysts covering them. And most of these companies are very good companies. The average company in the S&P 500 has a return on equity of around 19%. So in the large-cap domestic market, what you have is a collection of very large, widely-followed, high-quality companies, and because of this, this market is relatively efficient, and most managers fail to outperform this benchmark over time.

Now let's compare this market to the small-cap market in the United States, which has approximately 3000 companies, an average market capitalization of $1.8 billion, and 6 analysts covering each company on average. And in this large universe of 3,000 companies, there's an extremely wide range in terms of the quality and sustainability of each business. And the average business in this benchmark is not as great of a business, with an average return on equity of around 10%.

So compared to the large-cap market, the small-cap market is much less efficient. You have more companies, fewer analysts covering each company, and a wider range of companies in terms of quality. And it's in this less efficient area of the market that Kayne Anderson Rudnick has developed an expertise over the last 20 plus years. Through our bottom-up research, we identify and invest in a select group of the highest-quality small-cap companies we can find, companies that have high returns on invested capital, strong balance sheets, and much more consistent growth than your typical small-cap company. As a result, the companies that we invest in behave much more like blue-chip companies even though they reside in the small-cap market. And because this market is less efficient, we're able to invest in these companies at valuations that allow us to generate strong investment returns over time while taking on less risk than our benchmark, which is the Russell 2000.

Since our inception in 1992, our flagship Small Cap Core strategy has outperformed the Russell 2000 by 3% annually, and we've been able to achieve these returns with much less risk and volatility. Over the last 22 years, the Russell 2000 has declined in seven of those years, and over this same time period, our portfolio has declined in only two of those years.

Now if you take those elements that have allowed us to achieve these investment returns – a large universe of companies, less Wall Street coverage of each company, and a wide range of companies in terms of quality, these factors exist to an even greater degree in the international small-cap space where we have a universe of over 15,000 companies, on average only three analysts covering each company, and once again, a wide diversity in terms of quality of each business. So in this even less-efficient market, we are able to put together a group of the same high-quality companies that we've always invested in, but we're able to do so at much more attractive valuations.

A good example of this is our investment in AIT Corporation. This is a company that we've owned in the portfolio since inception of the strategy just over three years ago. AIT is an international freight-forwarding company based in Osaka, Japan. Their business model is extremely similar to a company called Expeditors International of Washington, which is a company that we've owned and followed in our domestic small and mid-cap strategies for over a decade. Both of these companies have all of the things we look for in a business: strong competitive protections, high returns on invested capital, an extremely strong balance sheet, and excellent growth in revenues and earnings over time. But because Expeditors is traded domestically, and now has a market cap of over $8 billion, the high-quality nature of this business is no longer a secret. The company has over 20 analysts covering it, and the stock consistently trades at 20 to 30 times earnings at least, and sometimes even higher. Now contrast this with AIT, which at the time we purchased shares, was a small-cap company located in Osaka, Japan, with literally no analyst coverage. The company traded at less than 10 times earnings, with 40% of the market capitalization in cash on the balance sheet and no debt, and a dividend yield of over 4%. And this is for a company that had been growing, and continues to grow, at double-digit rates in terms of revenues and earnings. So this is one example of the type of valuation discrepancies that we've been finding in high-quality small-cap companies internationally, but this example is not an exception.

Our current portfolio has an average return on equity of 22%, trades at 12 times trailing earnings, and has a dividend yield of 4.1%. And once again, this is for a collection of companies that have been growing at double-digit rates over the last 5 and 10 years. So when you compare this to the S&P 500 which has a P/E of 18.6, the Russell 2000 which has a P/E of 22.7, or the small-cap international benchmark which has a P/E of 20, we think the prospects for this portfolio in both absolute and relative terms are definitely attractive.

So, in summary, we think that investors should consider an allocation to the international small-cap asset class due to the inefficient nature of the market and the exceptional investment opportunities this can create. And we feel that the International Small Cap strategy at Kayne Anderson Rudnick, which owns a group of high-quality small-cap companies trading at attractive valuations, is a good way to get access to this asset class.

Thanks again for listening to the podcast, and of course, if you have any questions or comments, please don't hesitate to contact us.

A complete list of portfolio holdings and specific securities transactions for the preceding 12 months is available upon request. Holdings are subject to change. All information is provided for informational purposes only and should not be deemed as a recommendation to purchase the securities mentioned. Kayne Anderson Rudnick has chosen to review the securities in this document based upon objective criteria. It should not be assumed that securities recommended in the future will be profitable.

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