KayneCast

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Episode 22

Second Quarter 2015 Review of the Small Cap Core Portfolio

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Hello, I'm Jon Christensen, co-Portfolio Manager on the Kayne Anderson Rudnick Small Cap Core portfolio. Today I will review our portfolio with a general market overview of the second quarter in 2015, discuss the drivers of performance, talk about new names and sales in the portfolio, and conclude with a market outlook.

After last quarter's 4% rise in the Russell 2000 Index, the second quarter of 2015 was somewhat more muted, with the Russell up a slight 0.4%. This was in comparison to the just less than 0.3% return for the S&P 500. In general, growth outperformed core and value investment styles.

The sectors that drove the performance in the quarter were health-care, technology, and financials. On the downside, utilities led the way with energy and basic materials also exhibiting weakness. So what types of businesses did drive the market? It was a somewhat more mixed quarter in terms of quality biases. While companies that have lower S&P stock rankings, and higher P/Es outperformed their counterparts on each of those metrics, stocks with low debt and lower betas also outperformed.

We once again believe it merits calling out health-care in particular as an outlier since it was a large driver of the Index's performance for the quarter. For some perspective, biotechs are now an over 8% weight in the Russell 2000 Index, up from 4% in 2012. In Q2, health-care was up over 5.7% versus 0.4% for the Russell Index. Of particular note, six of the top-10 contributors to the Russell 2000 in Q2 were biotech firms. Of those six, every one of them were not profitable, and as you know, we do not invest in businesses that are highly speculative and do not make money.

Our Small Cap Core portfolio slightly trailed the Russell 2000 Index. Given the issues discussed previously—in particular the biotech headwind we encountered—we believe the performance on this short-term basis is understandable. The highest contributors for the quarter were MarketAxess, Aspen Technology, and Sirona Dental Systems. I'll say a few words about Sirona, which is a provider of dental equipment including imaging products, instruments, and CAD/CAM systems. The shares have benefited from the increased penetration of its CEREC CAD/CAM system into dentists' offices that allow them to perform a greater number of procedures such as crowns and implants more efficiently and with greater patient experience. The company's technology differentiation and market-share in the dental market provide them attractive long-term growth prospects.

Among the stocks that lagged in the quarter were Shutterstock, Abaxis, and Primerica. Shutterstock operates an online marketplace that allows customers to search and license commercial images from freelance contributors around the world. The shares have been under pressure following Adobe's acquisition of rival Fotolia. Some investors believe that Adobe could leverage its corporate relationships to grow Fotolia at Shutterstock's expense. However, we believe these concerns are overdone, as Shutterstock's marketplace continues to see robust growth on both the contributor side as well as image uploads given their strong network effect.
We added three new businesses in the portfolio this quarter, those being PriceSmart, Teledyne, and Dril-Quip. PriceSmart owns and operates warehouse clubs in the United States, Latin America, and the Caribbean. Its warehouse clubs sell consumer goods and perishable items at low prices to individuals and businesses, as well as offering many ancillary services, including tire and photo centers.

PriceSmart is a leader in the warehouse club retail sector in the Latin and Central American markets. The company had no direct competitors in those markets and the markets are not necessarily large enough to support two competing warehouse offerings. The company has been a consistent grower with improving returns on capital and a very healthy balance sheet with low leverage.

Teledyne manufactures high-tech products for industrial applications that are typically in industries that are highly regulated such as Aerospace. The company's products are highly engineered and sophisticated [and] that require extensive R&D which results in having few, if any, competitors.

Dril-Quip designs and makes engineered offshore drilling and production equipment including subsea wellheads and production trees. The company has a solid reputation for reliability and holds a 40% market share in global subsea wellheads. With the energy sector taking a significant hit over the past year, this was an opportunity for us to invest in a high-quality business trading at a low valuation that we believe has solid long-term prospects.

We sold five names in the quarter, those being ANSYS, Brown & Brown, Owens & Minor, Rollins, and Blackbaud. ANSYS was sold mainly due to its large market cap of over $8 billion. We have had the name in the portfolio for over 12 years. Brown & Brown was sold due to our lower confidence in their business model of perpetual M&A being able to grow returns over time. Owens & Minor has been pursuing an M&A strategy towards more commoditized products that we believe is eroding return on capital and their pricing power over the past few years. Rollins was sold after 11 years in the portfolio due to valuation and other more compelling long-term opportunities. Lastly, Blackbaud was sold due to valuation and their prospects for future growth.

Let's talk about the market outlook. After several years of observing a low-quality tailwind in equities, we have been experiencing a reversion as the economy continues to have some hurdles to overcome to improve the sluggish nature of this current recovery. We believe a reversion to the mean in returns is underway and appropriate as interest rates seep back up, and the current geo-political environment creates volatility and an unsettling future for global growth rates.

Putting this all together, we believe the market is in the process of adjusting for these factors. So our contention is that over the long term, you want to own high-quality businesses that have a sustainable competitive advantage, can outgrow their markets, with low debt and strong free-cash-flow, [and] that trade at discount multiples to the greater market.

Our portfolio continues to look favorable versus the benchmark on these types of metrics; return on equity of 24% versus 10% for the Russell 2000 benchmark, debt-to-EBITDA of 0.9 versus 5.1, EPS growth in the last 10 years of almost 12% versus 6% for the Index, and our current P/E on a trailing-twelve-month basis is over [an] 11-times discount to the Index.

This is why we favor our high-quality bias over the long term. That's where we invest. That's our history and our future. Thank you for your time, interest, and continued trust and confidence.