KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 24

Second Quarter 2015 Review of the Small Cap Quality Value Portfolio

Craig Stone
Portfolio Manager & Senior Research Analyst

Hello, this is Craig Stone, Portfolio Manager at Kayne Anderson Rudnick. Today I will be making some brief comments on the second quarter equity market along with some highlights of our Small Cap Quality Value Portfolio.

This past quarter, growth stocks continued their outperformance over value stocks, a trend that has been in place for the past four quarters. In Q2, the Russell 2000 Value benchmark actually saw a negative return, and our performance was pretty much in line with the benchmark during the quarter. Investors' preference for growth stocks hurt the value benchmark overall, with only the health-care and financial sectors posting a positive return within the Russell 2000 Value benchmark. But unlike the Russell 2000 Growth Index, the health-care sector has one of the smallest weights within the value benchmark. The slightly positive return of the financial sector in the benchmark has a much higher impact given the substantial weighting of financial stocks.

If you recall, six to nine months ago, we had called out the real estate investment trusts (or REITs) as having led the value index in terms of weighting and performance. What a difference a few quarters can make. The North American REIT Index declined nearly 9% in Q2 alone. This now puts the YTD performance of REITs at over negative 5%. We sold our last REIT holding in Q2 last year due to valuation reasons and the lack of exposure to the industry hurt our performance last year. Conversely, the lack of REIT exposure has benefited our portfolio's performance this year.

Additionally, though small cap stocks only slightly outperformed their larger counterparts in Q2, this continues a trend that has been in place since the beginning of this year. One of the main reasons for the small-cap outperformance has been investors' concerns about strength of the U.S. dollar and its impact on multi-national large-cap companies' foreign currency exposure.

Yet small caps are not fully immune to the foreign currency volatility. Even small-cap companies have foreign revenue exposure, particularly in more global industries like industrials and technology. However, the total foreign exposure for small caps overall is still far less than larger-cap companies. Our Quality Value portfolio, at year-end 2014, had revenue exposures outside of North America of less than 25%. This is contrast to multi-national large-cap companies that typically get the majority of their revenues from outside the U.S.

In conjunction with foreign currency, the Chinese stock market has also been dominating the headlines recently with its volatility. While it does not have a direct impact on our portfolio, there could be some economic implications for China and for some of our industrials and technology companies that have enjoyed the growth previously seen in Asia Pacific. If you are interested in understanding more about the global impact that China may have, my colleague James Fletcher, who co-manages our Emerging [Markets] Small-Cap strategy, has done a recent podcast on this very subject that is available also on our website. I encourage you to listen to it.

As I mentioned earlier, our portfolio's performance was somewhat in line with the benchmark this past quarter, but year-to-date and over [the] trailing 12 months, we have outperformed. In fact, while the benchmark is up just under 1% over the trailing 12 months, our portfolio has seen significant outperformance over the same time period.

From a sector standpoint for the quarter, we had good stock selection in producer durables and financial services while stock selection in technology and consumer discretionary detracted from performance.

The company that contributed most to performance during the quarter was Cheesecake Factory. After a disappointing fourth quarter, Cheesecake Factory far surpassed expectations in the quarter. Same-store sales increased well ahead of other restaurant industry competitors, helped not only by pricing but improving traffic as well. Further, the company still has not instituted [a] wide regional pricing strategy that could be used to further offset higher minimum wage levels in states such as California. New restaurant openings are on track for the balance of the year and international restaurant openings via licensing partners are meeting or beating expectations as well. We took advantage of the weaker stock price post fourth quarter earnings' disappointment and added to our position in the first quarter of this year. Thus far it has worked out well.

The companies that contributed least to performance during the quarter were Monotype Imaging and Wolverine World Wide. Monotype Imaging develops and licenses font and technologies for creative applications and consumer-electronics devices. The company reported healthy growth in its Creative Professional business, which will be the long-term growth driver of the company. That said, disappointing printer sales, particularly in China, which is still a large share of the company's revenue and growth, will likely be more muted over the medium term, and the decline in printer revenues likely surprised investors who saw this as a slow but growing business. Longer term however, we expect that the printer business will stabilize and that investors will focus more on the faster-growing Creative Professional segment and drive the share price higher.

The second stock is Wolverine World Wide, which engages in designing, manufacturing, and distributing to the retail sector branded footwear, apparel, and accessories. The company owns such well-known brands as Merrill, Sperry, Keds, and Saucony. Wolverine reported somewhat subdued Q1 results that were partly due to currency headwinds, but also driven by restructuring changes within its portfolio. Management lowered guidance, which sent the shares down significantly early in Q2. However, with Q2 earnings now reported, the stock has made a slight rebound, still trailing the benchmark year-to-date, but still showing substantial outperformance over the past 12 months.

In closing, we are encouraged that the equity market is starting to embrace the type of quality businesses in which we invest. We continue to believe that the risk/reward ratio for equities over the long term is favorable on an absolute basis and particularly relative to fixed income. We also believe that investors should expect more modest equity returns going forward than what we have seen over the past years. It has been a while since the market has seen a 10% correction. While we are not calling for imminent correction, it is a natural and healthy part of the equity market progression. What we do know for certain is that our investment philosophy lends itself to better capital preservation, particularly during tough equity environments.

Thank you for listening to this recording and as always we welcome any questions or comments you may have.