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Episode 33

Fourth Quarter 2015 Review of the Global Dividend Yield Portfolio

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Hello, I'm Richard Sherry, Portfolio Manager on the Kayne Anderson Rudnick Global Dividend Yield Portfolio. Today, I will discuss recent performance and activity in the portfolio.

Before we discuss fourth-quarter results, recall that during the third quarter, investor nervousness regarding economic growth and corporate profitability weighed on global markets. These concerns were compounded by nervousness around the Fed's "will they"or "won't they" approach to interest-rate increases. As is typically the case when investors are concerned about an economic slowdown, the Global Dividend Yield Portfolio outperformed.

Markets subsequently rebounded in October and although they drifted lower in November and December, they advanced nicely for the fourth quarter. The Global Dividend Yield Portfolio also advanced during the quarter, but as is usually the case in a bounce-back rally, the portfolio underperformed somewhat. It produced a positive return of 2.8 percent in the fourth quarter as compared to positive returns of 5.3 percent in the Russell Global Large Cap Developed Index, 7.0 percent for the S&P 500 Index, and 4.8 percent for the EAFE International Index.

During the fourth quarter, higher quality stocks held up relatively well, as investors remained concerned about economic growth. The Global Dividend Yield Portfolio's underperformance was mostly related to what happened in two economic sectors: energy and information technology.

In the energy sector, an acceleration in the decline of the price of oil resulted in investors putting significant pressure on those companies that were considered in danger of cutting the dividend. One of those companies was Kinder Morgan, which we owned. Kinder Morgan is a pipeline company that, for the most part, transports natural gas for a fee that is independent of the price of the underlying commodity. Pipeline companies return the vast majority of the cash flow that they generate to shareholders via dividends and fund growth projects via the equity and debt markets. Although this results in a business which is somewhat more levered than we would normally own, we were comforted by the relatively steady cash flows that the business generates. Our analysis (and subsequent comments by the company) indicated that the company's strong fee-based business would generate enough cash flow to cover the dividend in the current environment. However, a small acquisition in early December led to a warning from one of the credit-ratings agencies about a potential downgrade. At this point, we became concerned enough about the company's ability to access the capital markets and to manage through the current environment without cutting the dividend that we sold our position. But not before the stock had declined quite a bit during the quarter.

One of the tenets of our investment philosophy is to provide an above-average dividend yield with less equity risk. One of the ways that we achieve that is by focusing on businesses that produce solid cash flow and can maintain a dividend in good times and bad. That focus contributes to a reduced level of risk in the portfolio. When it becomes apparent that a dividend cannot be maintained at its current level, we sell the position.

In the case of the information-technology sector, it was less about what we owned and more about what we didn't own. In an environment in which investors were concerned about economic growth, they gravitated towards businesses that have been able to produce growth even in the current economic environment. The businesses that we own in the information-technology sector did well, especially Paychex and Microchip Technology. They just didn't do as well as companies such as Alphabet Inc. (formerly known as Google) and Facebook, which were both up more than 15 percent during the quarter.

On the positive side, many of our steady-eddy longer term holdings did very well during the quarter. That included Realty Income (also known as The Monthly Dividend Company) which is a real estate investment trust that owns and manages commercial properties and has paid dividends for 546 consecutive months. Our winners also included the cigarette and tobacco company, Philip Morris International, and Kimberly Clark, which among other things makes Huggies diapers and Kleenex tissue.

During the quarter we initiated new positions in two companies. Cobham is a UK-based defense and commercial-services company that specializes in products that send and receive signals. The company produces products for satellite and antenna systems, provides refueling systems for the global defense industry, and has a specialized aviation-services business. The business generates mid-teens operating margins and the free cash flow which the business produces has allowed the company to maintain or increase its dividend for 43 straight years.

We also initiated a position in WEC Energy. Formerly known as Wisconsin Energy, WEC Energy provides electric-generation and natural-gas distribution services in the upper Midwest. The company benefits from ownership in some assets that produce an above-average return on equity for a utility. Historically, utilities which produce strong returns on equity have tended to outperform other utilities. First, WEC has about 10 percent of its assets in a non-regulated subsidiary whose assets are leased back to WEC under long-term 25-to-30 year leases. These assets produce a higher-than-normal return on equity for a utility and produce strong free cash flow. In addition, the company also owns approximately 60 percent of American Transmission Company, which is a transmission-only electric utility that is regulated nationally, not at the state level. Transmission utilities are allowed to earn an approximate 12 percent return on equity, above the typical 10 percent allowed return by most states.

In terms of what we sold during the quarter, in addition to Kinder Morgan, we also sold Artisan Partners. Artisan Partners is an investment-management firm that has historically returned a large portion of its cash flow to shareholders via dividends. However, the business has been negatively impacted by poor performance at some key products that have contributed to net outflows. Although the company has some opportunities in newer products with favorable track records, many of its best performing products remain closed and are unable to offset outflows elsewhere. We are concerned that the pressure from net outflows will continue and have become less certain about when a turnaround in net flows will occur and as a result, have decided to sell our shares.

Early in 2015, markets first began to sense that the Federal Reserve might start to raise short-term interest rates. This resulted in a period of underperformance for the portfolio that is to be expected when markets begin to price in the impact of a gradual move higher in interest rates. In fact, since the first quarter, the portfolio has performed in line with the market in a somewhat choppy trading environment. It is a large (one-to-three percentage points or more) unexpected move higher in interest rates that has the potential to produce a greater level of underperformance for the portfolio.

As we enter the New Year, we have seen markets continue to be volatile to the downside as concerns about global growth rates continue to hang over the market. The Global Dividend Yield Portfolio has performed as expected through January, producing slightly positive returns compared to a decline of mid-single digits for the Russell Large Cap Developed Index and other comparable benchmarks. These results are driven by our philosophy of investing in a diversified portfolio of high-quality mature companies that are of a durable nature, that generate strong cash flow, and have solid balance sheets. These kinds of businesses are generally favored by investors in times of economic uncertainty.

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