KayneCast

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Episode 4

First Quarter 2014 Review of the Small Cap Quality Value Portfolio

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Hello, this is Craig Stone, co-Portfolio Manager of the Kayne Anderson Rudnick Small Cap Quality Value Portfolio. I would like to briefly offer some comments regarding the equity markets and also our Q1 portfolio performance.

It was a very interesting first quarter for the equity market. January saw a decline of nearly 4% in the Russell 2000 Value Index. This was followed by the index being up 4.6% and 1.2% in February and March, respectively.

And through the first 15 days of April, the Russell 2000 Value Index is already down 3.2% month-to-date. Certainly this is a lot of volatility from month-to-month for the index, and though I am giving you just the numbers for the Russell 2000 Value Index, all of the major equity indices have seen similar return patterns. All of this, of course, follows Q4 last year where equity returns were very strong.

And as for the portfolio, like the recent swings of performance that we have seen in the equity indices, we have also seen several of our portfolio stocks having significant fluctuations and affect our performance in Q1. Again, this comes after our portfolio's outperformance in Q4 last year.

But let me offer you a couple of examples of the near-term fluctuations among our holdings:

Cass Information Systems, ticker CASS - which is a unique banking model and transportation payment processor - saw its shares decline nearly 20% during the month of January alone. Now, while we do not believe that there was a credible fundamental reason for the sharp price decline, CASS did see its stock price appreciate over 26% in Q4 last year and ended 2013 with a total 62% return. So perhaps the equity market decline in January drove investors to take profit in the stock of CASS without regard to fundamentals. Perhaps the decline of the 10-year bond rate from 3% back down to 2.6% led to less enthusiasm for CASS near term. But from our perspective, the enthusiasm for CASS one quarter and the harsh dislike in the subsequent quarter, does not affect our long-term outlook for this great business.

Another similar example of the current market dynamics is that of RLI Corp, ticker RLI - a specialty insurance underwriter which we also own in our portfolio - which similarly saw its stock decline nearly 14.5% during the month of January. And like that of CASS, the stock had a strong Q4 last year with price appreciation of over 15% and a total 2013 return of nearly 58%. There was no, again, fundamental reason for the stock weakness that would explain the sharp price movement of this company from quarter-to-quarter.

But this is not to say that the portfolio had no stocks where fundamentals drove stock performance higher or lower. In fact, in Q1 we did have stocks like First Cash Financial, ticker FCFS - an operator of pawn stores in the U.S. and Mexico - along with CLARCOR, ticker CLC - a provider of aftermarket truck engine filters – where disappointing earnings announcements in Q1 did lead to share price declines. But in both cases we deem these to be temporary, cyclical events and not structural fundamental changes to these businesses. Therefore, we remain very confident in the businesses and will continue to own both stocks for their long-term return potential.

In summary, while we are not happy with the underperformance of our portfolio relative to the Russell 2000 Value benchmark in Q1, we are not letting these short-term events or near-term volatility drive our decision to remain focused on the long-term outlook for our companies and our portfolio.

We also understand that the investment philosophy of owning high-quality businesses can face headwinds or tailwinds during certain periods of time. And despite the Small Cap Quality Value Portfolio's outperformance in 2013, we have seen headwinds toward quality investments for the better part of 2013 and into the current year as well. This is where investment-grade rated companies have seen lower return than below investment-grade rated companies, where higher-beta companies outperformed lower-beta companies, and where companies with low or no earnings did not necessarily underperform as we would typically expect. To us, all these attributes point to a favorable headwind and outperformance for low quality over high-quality businesses.

Nonetheless, this will not alter our belief that investing in high-quality businesses will trump investing in low-quality businesses over a long period of time. In fact, our discipline of being a high-quality investor has been proven through our long-term alpha generation, and the recent short-term noise will not dissuade us from being high-quality investors.

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