KayneCast
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Episode 9

Second Quarter 2014 Review of the Small Cap Core Portfolio

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Hi, I am 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 2014, discuss the drivers of performance, talk about new names in the portfolio, and conclude with a market outlook.

So let's talk about the second quarter. For the second quarter in a row, small caps in general underperformed larger stocks. This was of course after small caps – identified as the Russell 2000 Index – posted their highest five-year rolling return in 16 years.

The quarter's monthly activity could be summarized as bifurcated, with April returns being negative by almost 4%. May was up slightly, and June was stronger by over 5%. So, overall, the Russell 2000 Index finished up about 2% for the quarter. The sectors that drove the performance were energy, utilities, and financial services. Despite the fact that the market was up a mere 2%, no sector was negative.

So what types of businesses excelled in this environment? Similar to what we saw in Q1, companies with high betas, high P/Es, and high debt on their balance sheets outperformed their counterparts on each of those metrics. For example, stocks with betas over 2 were up 4.8% while those in the 0.5 to 1 range - where we have over 50% of our portfolio - were up 2.6%. Also, stocks that had levered balance sheets of 30% to 70% debt to capital were up 4% while companies with no debt - where we play - were down 1.6% in the quarter.

Despite the aforementioned tailwind of low quality in the market, our Small Cap Core portfolio outperformed the overall market by about 2% in the quarter. How, you may ask, was this achieved? It really came down to holding up much better in the down part of the quarter – which you should expect from us – and keeping up in the market surge in June due to solid stock selection, with one name in particular announcing it was being bought at a hefty premium.

That stock was Hittite Microwave. Hittite Microwave designs and develops high-performance analog and integrated circuits for various demanding radio frequency and microwave applications. We originally bought the shares into the portfolio almost four years ago in 2010. In early June, the company announced it was being acquired by Analog Devices at a nearly 29% premium to the previous days' share price. This was the number one contributor to the portfolio in the quarter.

We also had two other names that outperformed in the quarter. Those were Sirona Dental and Abaxis. Sirona is a manufacturer of dental technology and equipment including CAD/CAM systems, imaging and instruments. Sirona was a name that had actually lagged in performance over the past 12 months prior to this quarter. The shares rose in Q2 after showing solid Q1 financial results where its CEREC CAD/CAM system is seeing growth in dentist offices while the overall dental market remains benign. We believe Sirona's technological differentiation continues to make this company an attractive long-term investment.

Abaxis is the other company. They are a manufacturer of blood diagnostic devices sold through both medical and veterinarian channels that provides blood-test results in doctors' offices in 12 to 13 minutes, versus a traditional lab which comes back days later. Abaxis saw its shares drive higher in the quarter as the company's new third-party distributors are seeing improved sales after a year of inventory disconnect that led to weaker top-line results. The company's systems are being adopted in vet clinics and labs as well as in the human medical market, with retail opportunities such as drug stores being another leg of growth potentially.

We added two new names in portfolio in the quarter. One was MarketAxess. MarketAxess operates the leading electronic trading platform for U.S. corporate bonds. So, MarketAxess's electronic trading platform provides the greatest liquidity, which benefits both buyers and sellers by providing the best chance of matching bond orders at the best price. While there are real barriers to the broad adoption of electronic bond trading, MarketAxess has a position within the institutional, small-order market that is durable and likely to grow over time.

The other company we purchased was CDW. CDW provides technology solutions for business, government, education, and health-care customers. As a value added reseller, the company focuses on small and medium-sized organizations - which are defined by 5,000 employees or less - where it can provide the most value. CDW acts almost as an outsourced IT provider to customers. Customers look to CDW to provide unbiased guidance with the right solution as their technology needs evolve.

Now let's talk a little bit about the market outlook. So we have come through the second straight kind of "ho-hum" quarter here, if you will, after the last few years of robust returns for small caps. While we continue to believe that the risk-reward ratio for equities over the long run is favorable, we believe 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 weak GDP numbers continue to post, 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 given the robustness we have seen. So our contention is that over the long term, you want to own high-quality businesses that have sustainable competitive advantages, outgrow their markets, with low debt, and strong free-cash-flow that trade at discount multiples to the greater market. Our portfolio continues to look favorable versus the benchmark on these types of metrics.

For example, return on equity in our portfolio is around 20% versus 9.5% for the greater index. Debt/EBITDA of 0.8 versus 4.6 for the index - our companies have a lot less debt on the balance sheet. EPS growth over the last 10 years; 11% for our portfolio, 6% for the index, and our portfolio is currently trading at an 11-multiple discount to that of the market.

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