Episode 42

Third Quarter 2016 Review of the Small Cap Core Portfolio

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Hello, 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 third quarter of 2016, discuss the drivers of performance, talk about new names in the portfolio, and conclude with a market outlook.

The third quarter of 2016 saw an acceleration of performance in small caps in particular, with the Russell 2000 Index growing over 9 percent in Q3. After the Brexit vote and its aftermaths calmed down, global growth prospects seem to stabilize, which encouraged investors to favor more risk-based assets. By month, July was the strongest, with the Russell 2000 growing almost 6 percent. August and September calmed down a bit, but growth was still seen in the 1.7 and 1.1 percent returns respectively. As I said, by the end of the quarter, the Russell 2000 Index was up over 9 percent in the quarter. This was in comparison to the 3.8 percent positive return for the S&P 500. So small caps were once again the place to be in the quarter.

The sectors that drove the performance in the quarter were: technology, health care, and energy. On the downside, utilities, consumer staples, and consumer discretionary sectors all lagged. So what types of businesses did drive the market? The small-cap market was decidedly low quality driven this quarter. Companies with low S&P stock rankings, high P/Es, high betas, and carrying high debt loads on their balance sheets all outperformed their counterparts on those metrics.

To give you some numbers that demonstrate this: stocks that had S&P stock ratings of B or lower—which we view as low quality—were up over 10 percent in the quarter, while those with ratings of B+ or higher were up only 3.7 percent. Even more telling was that stocks with betas over two increased almost 20 percent in the quarter, while those between 0.5 and 1 (where we have the majority of our holdings) were up 4.45 percent, a differential of about 15 percent. So clearly the tailwinds were in low quality's favor.

Our Small Cap Core Portfolio underperformed the Russell 2000 Index by over 500 [basis] points in the third quarter. Given the overwhelming bias towards low quality in the quarter, these results are somewhat predictable given our high-quality philosophy. We had a few names that drove some of our outperformance for the quarter: Shutterstock, Autohome, and CDW.

We talked about Shutterstock last quarter, so let me go into a little more detail on Autohome and CDW. Autohome is the holding company for several China-based websites focused on the consumer automotive industry. We have discussed this company in the past, but under the context of our lower performers. Users of Autohome's websites can research professional and user-generated reviews of private passenger vehicles sold in China. The shares had been under pressure for the past year due to: one, investments in a new car transaction business at the expense of near-term margins; and two, management upheaval following Telstra's decision to sell its controlling stake to Ping An Insurance. With Ping An now in control, the new management team has indicated a greater discipline in how money is spent and capital is invested in the new car transaction business. Meanwhile, the core auto review business remains extremely profitable, and is growing in excess of 20 pecent. The removal of some uncertainty and the prospect for improved margins has benefited the shares recently. Given the expected long-term growth of the Chinese car market and the potential for new management to adjust the company's investment strategy to be more disciplined, we remain owners of the business.

CDW: CDW engages in the provision of integrated information technology solutions. Its offerings range from discrete hardware and software products, to integrated IT solutions, such as mobility, security, data-center optimization, cloud computing, virtualization, and collaboration. It operates through the corporate and public segments. In CDW's last earnings release, the company reported solid growth in its public markets that more than offset some of the more muted spending among its medium and large corporate customers. Management commented that this slowdown appeared to be temporary. The company continues to sell its solutions well, which further embed it with its customer base.

Stocks that lagged in the quarter: Computer Programs & Systems, Exponent, and Primerica. We've talked about Computer Programs & Systems last quarter, so let me give you some color on Exponent and Primerica.

Exponent provides science and engineering consulting services to commercial clients in the U.S. and abroad. Its expertise in engineering has made Exponent's expert analysis crucial in the legal realm. Stock performance lagged in the quarter as reactive work slowed and weakness in energy end markets started to flow through. Despite the short-term lumpiness, we remain confident that Exponent's brand and reputation will enable them to generate excellent long-term returns.

Primerica: Primerica underwrites and distributes term life insurance and sells third-party mutual funds via independent representatives to middle-income households in the United States and Canada. The company has the largest life insurance distribution force in the country. Shares had been under pressure for the past year due to concern regarding how the Department of Labor's Fiduciary Standard Rule (also known as the "Rule") would impact the retirement investment account industry. The final language of the Rule was less onerous than feared, which sent Primerica's shares higher in Q2. However, some questions remain over the ultimate cost to firms to implement the Rule, which has left an overhang on many firms, including Primerica. Therefore, despite reporting earnings per share in the most recent quarter that grew in excess of 20 percent, the shares remain somewhat under some pressure. We continue to believe the long-term earnings power of the business has not been materially altered by the Rule, so we remain owners of the business.

We had two new purchases, but no outright sells in the quarter. The two new buys were WABCO Holdings and Polaris. Let me tell you a little bit about each.

WABCO Holdings provides electronic, and mechanical products for commercial trucks, trailers, buses, and passenger car manufacturers. The company also manufactures and sells control systems, including advanced braking, stability, suspension, and transmission control that improve vehicle performance and safety and reduce overall vehicle operating costs. The company's products are utilized for heavy and medium-sized trucks, trailers, and buses. WABCO's products are key components to the safety of commercial trucks and are designed in on the front-end of the vehicle production cycle. As a result, its engineers work with OEMs years before production begins on a new truck platform. WABCO typically enters into long-term contracts with its OEM partners. These long product life-cycles, low production volumes relative to cars, and the importance of these products to the overall safety of the vehicles has resulted in a near duopoly of this market. WABCO has manufacturing capabilities around the world, which allow it to cost effectively source and supply truck OEMs on a global basis. These scale advantages have also enabled the company to expand gross margins while providing price reductions to OEM customers that range from 1 to 2 percent annually. Gross margins have averaged 30.8 percent over the last five years and have increased over 400 basis points during that time. Revenues have grown at a 5-year CAGR of 3.8 percent due to strong growth in the U.S. and a still slow recovery in the key European market. During the five years prior to the financial crisis, revenues grew at a 5-year CAGR of 18 percent.

Polaris Industries: Polaris designs and manufacturers recreational and utility vehicles, including off-road vehicles, on-road motorcycles, snowmobiles, and replacement parts and accessories. The company markets its products through 1,850 dealers in North America and 1,400 dealers outside of North America. Polaris' end customers are powersport enthusiasts who tend to be loyal to a particular vehicle maker. The users often personally associate with their vehicle brand; are accustomed to the mechanical, operational, and ergonomic aspects of the vehicle; and often wear the associated brand apparel. These purchasing attributes, combined with elements of economies of scale, a relatively small industry, and modest market growth, lead to a relatively concentrated competitive structure with infrequent changes in the lineup of manufacturers. Vehicle manufacturers reach their end customers through dealer relationships. An extensive and high-quality dealer network takes many years to develop. Dealers make a significant financial, operational, and reputational commitment to the vehicle manufacturers they choose to represent, and will naturally favor popular trends. This large network of dealers makes it more difficult for a new competitor to emerge.

Let's take a look at our market outlook. After seeing a volatile start to the year, the market has seen a steady pace upward as we have been experiencing overall solid earnings reports for U.S. companies, despite a slower global growth rate environment as well as continued stability in the oil markets. While we have been having these recent quarters of high and low-quality tailwinds trading places, we continue to believe that stock picking matters in all environments, especially those with more benign long-term GDP growth expectations, which is where we are today. So our contention is that over the long term, you want to own high-quality businesses that have a sustainable competitive advantage, outgrowing 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. We have currently a return on equity of 25 percent for our portfolio versus 10 percent for the Index, debt to EBITDA of 1 times versus 6.1 for the Index, EPS Growth the last 10 years for our portfolio is 12.4 percent versus 6.4 for the Index, with a trailing P/E in our fund of 22.4 versus 34.7 for 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.