KayneCast

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Episode 46

Fourth Quarter 2016 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 fourth quarter and full year of 2016, discuss the drivers of performance, talk about new names and sells in the Portfolio, and conclude with a market outlook.

The fourth quarter of 2016 saw an ongoing strong performance in small caps, in particular with the Russell 2000 Index growing almost 9 percent in Q4—fairly similar to the results we saw last quarter. After the Presidential election in early November, the market accelerated in hopes of a Trump administration that would be positive for U.S. based, infrastructure-related, high corporate tax paying companies. Whether or not these beliefs play out are still to be seen, but investor enthusiasm was obvious. By month for the Russell 2000 Index, October was down almost 5 percent and then after the election, euphoria set in, driving the market up 11 percent in November. December was a little more muted, but still rose almost 3 percent. So the 8.8 percent return for the Russell 2000 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 financials, energy and materials. On the downside, health care, technology and consumer staples all lagged. So what types of businesses did drive the market? The small cap market was mixed in terms of quality for the quarter. Companies with high S&P stock rankings, low P/Es, low betas all outperformed their counterparts on those metrics. On the other hand, stocks with low credit ratings, higher debt on their balance sheet and low ROEs also outperformed. So the overall market was benign in terms of high versus low quality. Our Small Cap Core Portfolio underperformed the Russell 2000 Index by about 220 basis points in the 4th quarter. With a neutral quality bias in the market, stock selection was more pronounced in determining the performance. Poor stock selection in consumer discretionary and financials were the main reasons.

Focusing more on the year 2016, it was definitely the year for small caps overall. The Russell 2000 Index grew over 21 percent in 2016 after a negative year in 2015, while the S&P 500 Index was up about 12 percent. When looking at the sectors that did well in 2016, they were materials, energy and financial services. The one sector that did poorly—the only one that was negative—was health care. Focusing on small caps, there was once again a mix in terms of low versus high quality, including those with high S&P stock rankings and low betas. The solid 21 percent return for the Index combined with sectors doing well that are normally associated with a low-quality slant created some headwinds for our type of investing. As a result, we slightly underperformed the Russell 2000 by about two percent in 2016.

We had a few names that drove some of our outperformance for the year: MarketAxess, Primerica and Toro. All of these stocks were up at least 30 percent in the year. We've talked about MarketAxess and Primerica in the past, so let me go in a little more detail on Toro. Toro is a leading provider of landscape maintenance equipment. Gross and operating margin continue to move up for Toro due to favorable commodity costs, increased productivity as well as product mix. Capital allocation for the year was tilted towards share repurchases due to lack of M&A. For the year, the company will have repurchased just under two percent of outstanding shares, and there is still seven percent worth of authorization left on the current repurchase program. We trimmed the position in Q4 due to near-term valuations.

The names that lagged for the year were Autohome, Computer Programs and Systems, and Artisan Partners. Speaking a little bit about Autohome, they are a holding company for several Chinese-based websites focused on the consumer automotive industry. Users of Autohome's websites can research professional and user-generated reviews of private-passenger vehicles sold in China. Users can also search local car-dealer inventory, and participate in car-buying promotions. The shares have been under pressure for the past year due to: 1) investments in new car transaction business at the expense of near-term margins; and 2) 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 percent. Given the expected long-term growth of the Chinese market and the potential for new management to adjust the company's investment strategy to be more cost disciplined, we remain owners of the business.

Let's talk a little bit about new names and sells in the Portfolio for the quarter. We had one new purchase and two sells in the quarter. The sole purchase was Old Dominion Freight Line. Old Dominion is the 4th largest less-than-truckload company in the U.S. (otherwise known as LTL). LTL freight is comprised of multiple customers' shipments per haul and therefore requires a network of service centers to sort and expedite the freight. This is in contrast to full truckload carriers who carry freight directly from a single customer to a particular destination. As one of the largest LTL carriers, Old Dominion's high volume of freight enables for efficient and low per unit handling costs, which in turn attracts more customers' freight. The network volume advantages in the LTL industry result in a relatively concentrated market where the top 10 carriers handle 80 percent of all LTL freight—in contrast to the highly fragmented full truckload carrier market—and create significant competitive barriers. Old Dominion has developed a reputation for high service levels that garner a premium price. They have also built a single integrated network operating on a common technology platform, which is in contrast to many competitors who have built their networks through acquisition and/or purchase external transportation capacity to fill in coverage gaps. Lastly, the management fosters a culture of high service, cost containment and price discipline.

The two sells were Landstar Systems and Computer Programs and Systems. Let's discuss each.

As a truck brokerage company with scale, Landstar is a solid business. Profitability is excellent and long-term growth has been reasonably healthy. The company also steadily repurchases its stock, pays a modest dividend and avoids acquisitions. However, we are selling our position in favor of Old Dominion, which we also view as a high-quality business but with somewhat greater growth prospects.

We sold our entire position in Computer Programs and Systems in the quarter after owning the business over 10 years. Our rationale was based on a few major items. 1) The health and financial stability of the company's major end clients (rural hospitals) continues to erode as larger urban hospitals continue to garner greater revenues from the Affordable Care Act as their utilization increases. This move has shifted spending away from rural centers and created more pressure on budgets. 2) CPSI itself has seen its business model devolve from a pure electronic medical records (or EMR) company to an acquisitive player in revenue cycle management and consulting. The acquisition last year of its Healthland peer is viewed—by us—as buying a much weaker clone of CPSI. 3) The company has taken on considerable debt for the Healthland deal. CPSI, before this, had been debt free. And 4) now that meaningful use is at the end of its cycle, EMR players are being assessed much more on their ability to attain population health needs as well as delivering cloud-based products. This, in our opinion, makes CPSI much more susceptible to competitive threats. Given these reasons, we have exited our position.

Let's switch to the market outlook. After seeing a sluggish first half of 2016, the market has seen a steady pace upward as we have been experiencing some sound earnings reports for U.S. companies combined with higher expectations coming out of the recent Presidential election. While we have had recent quarters of high- and low-quality tailwinds trading places, we continue to believe that stock picking matters in all environments, but 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 sustainable competitive advantages, outgrow their markets, with low debt and strong free cash flow that trade at a discount multiple to the greater market.

Our Portfolio continues to look very favorable versus the Benchmark on these metrics. The return on equity for this Portfolio the last 5 years is 26 percent versus 10 percent for the Index, debt to EBITDA of 1.2x versus 5x for the Index, EPS growth the last 10 years for our Small Cap Core Portfolio of 13.6 percent versus 6.4 for the Index, with a P/E in the Portfolio of 23x versus 36x 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.

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