KayneCast

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Third Quarter 2017 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 third quarter of 2017, discuss the drivers of performance, talk about new names and sells in the portfolio and conclude with a market outlook.

The third quarter of 2017 was again positive for equities with the S&P 500 returning 4.5 percent in the quarter. Smaller stocks outperformed their larger brethren, with the Russell 2000 Index increasing 5.7 percent—an acceleration from last quarter. It should be noted that small caps are still trailing larger caps on a year-to-date basis. With health care and tax reform outlooks oscillating between bright and dim, the market seems to be digesting these issues on a daily basis, but the strength of the market is a testament to overall solid corporate financial results. Which proves once again that in the end, what matters is picking high-quality businesses that can sustain growth in good and bad times. When dissecting the quarter by month for the Russell 2000 Index, July was up 0.7 percent, August was down 1 percent, and lastly, September was up a solid 6.2 percent.

The sectors that drove the performance in the quarter were producer durables, health care and energy. On the downside: REITs, consumer staples and utilities all lagged the benchmark. So what types of businesses did drive the market? The small cap market was biased toward lower-quality businesses. This is demonstrated by the following metrics: companies with low S&P stock ratings and low credit ratings, high betas, and high P/Es all outperformed their counterparts on those metrics. Our Small Cap Core portfolio outperformed the Russell 2000 Index by about 300 basis points in the third quarter. Superior stock selection in technology, consumer discretionary and producer durables drove the outperformance.

We had a few names that drove some of our outperformance for the quarter, including Autohome, Fox Factory and Teledyne. I've discussed Autohome and Fox in the past, so I will say a few words on Teledyne. Teledyne's subsidiaries manufacture sophisticated technology products for multiple industry applications. Many of these products are based on extensive engineering and sold into highly regulated markets. Additionally, Teledyne is viewed as a trusted acquirer by entrepreneurs looking to monetize their own ownership stake. In the quarter, the stock outperformed as energy end markets stabilized, digital imaging product experienced elevated demand, and management completed an attractive acquisition. The company's products continue to dominate niche industrial markets and capital allocation efforts remain superior.

The companies that lagged the most in the quarter were Abaxis, MarketAxess and Toro Company. Let me discuss some details on Abaxis. Abaxis is a manufacturer of blood diagnostic devices sold through both medical and veterinarian channels. It saw its shares fall in the quarter after reporting another weak sales quarter as its vet business grew slightly while medical was down due to distributor destocking. The company is ramping up its R&D efforts that should drive the top line, but this disconnect with the financials could continue for a few more quarters. The solid balance sheet and high consumables mix combined with a re-rating of the shares with future growth ahead keeps us as shareholders.

We had no new buys or any outrights sells in the quarter.

Now let's talk about our market outlook. Q3 of 2017 was a bit of a change from Q2 in that the market turned more lower quality in nature, which partially explains the acceleration in returns. 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 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 many of these metrics. The return on equity in this portfolio is 28 percent as of last quarter versus 10 percent for the Russell 2000 Index; debt-to EBITDA of 1.4 times for us versus 5.7 times for the index; earnings per share growth the last 10 years: 13.6 percent versus 6.8 percent. And lastly, a P/E on a trailing 12-month basis of 27.8 times for our portfolio versus 38.7 times for the Russell 2000 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.