Episode 55

Third Quarter 2017 Review of the Small Cap Quality Value Portfolio

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Hello, this is Julie Kutasov, Portfolio Manager for Kayne Anderson Rudnick's Small Cap Quality Value strategy. Today, I am here to provide a third quarter 2017 review and discuss specific stocks that have contributed positively as well as negatively to the overall performance.

Stock market returns were solid in the third quarter driven by improved business fundamentals, favorable economic data (such as benign inflation and low interest rates) and (towards the end of the quarter) renewed investor optimism over policy expectations, particularly as it relates to the tax reform. The S&P 500 Index advanced 4.5 percent, the Russell 2000 Index was up 5.7 percent and the Russell 2000 Growth Index was up 6.2 percent. Growth stocks continued to outpace value names and small stocks outperformed larger names during the quarter—the opposite of what occurred in the first half of the year.

The Russell 2000 Value Index, this strategy's benchmark, increased 5.1 percent in the third quarter bringing the trailing twelve months return to an impressive 20.6 percent.

In a reversal from the previous quarter, higher quality names underperformed lower quality names—not a favorable environment for us as high-quality investors. Despite that, our Small Cap Quality Value portfolio outperformed the Russell 2000 Value Index during the quarter by roughly 200 basis points primarily due to strong stock selection in the consumer staples, producer durables and material sectors.

The two positions that contributed most positively to performance during the quarter were National Beverage (ticker FIZZ) and RBC Bearings (ticker ROLL).

Some of you may recall our discussion of National Beverage in prior quarters. As a reminder, National Beverage manufactures and markets flavored beverages, including soft drinks, juices, teas and sparkling waters. It is the company's sparkling water LaCroix brand that has been driving National Beverage's robust growth in the environment where consumers have been shifting away from carbonated soft drinks to healthier beverages. We continue to believe that LaCroix has plentiful growth opportunities while the company's recent launch of Shasta flavored sparkling water may serve as another meaningful growth driver. Importantly, the company remains a solid free-cash-flow generator boasting a pristine balance sheet and returning excess cash to shareholders in the form of sizable special dividends.

RBC Bearings is a leading provider of highly-engineered precision bearings and components to the aerospace, defense and general industrial markets. RBC's products are engineered into customers' end products' design making them difficult to displace and creating a natural aftermarket for replacement parts. Shares performed strongly as the company benefited from a rebound in its commercial aircraft and industrial end-markets and achieved further profitability improvements. We remain optimistic regarding RBC's competitive positioning and the long-term outlook for the business.

The two stocks that detracted the most from the quarter's performance were Patterson Companies (ticker PDCO) and Cheesecake Factory (ticker CAKE).

Patterson is a distributor of dental and animal health products. As a distributor, the company provides value by connecting two highly fragmented markets: that of dental and veterinary practitioners and that of industry suppliers. Importantly, both dentists and vets exhibit a high degree of brand loyalty while supplies represent a small percentage of total costs of operating a dental or a veterinary office. Shares declined due to lower-than-expected operating results largely driven by the winding down of an exclusive distribution arrangement with DENTSPLY SIRONA for its CEREC product. CEREC is a CAD/CAM system used for tooth restoration and orthodontics which allows dentists to meaningfully streamline and simplify the process. A good example would be a dental crown procedure which traditionally requires at least two office visits—with CEREC, it's completed in a single visit. While the end of the exclusive arrangement with DENTSPLY does add to the uncertainty, we believe that any temporary disruption should be reduced over the next few quarters while new deals signed with other major CEREC manufacturers should offset some of the weakness.

Cheesecake Factory, as most of you probably know, is a chain restaurant operator. With the majority of its restaurants located either in or adjacent to malls, the company cannot be immune to the widely observed these days mall traffic slowdown. At the same time, it is fair to say that a Cheesecake Factory restaurant is a destination of its own. That's why the company has always been a desirable tenant for mall operators, allowing it to focus exclusively on the best or so-called "A-malls." An interesting fact illustrating the point: of over a hundred Macy's recent store closures, only one was in a Cheesecake Factory-adjacent location. We recently met with the company's management and came away impressed with operating improvements that are underway as well as a number of ongoing initiatives (including international expansion) that we believe should support earnings growth over the longer term.

We completed two new purchases during the quarter: that of Manhattan Associates (ticker MANH) and MGM Growth Properties (ticker MGP). We sold our remaining small position in Cabot Microelectronics (ticker CCMP) to buy MGM Growth Properties. We also sold our position in Sun Hydraulics (ticker SNHY), concerned with the company's new CEO having quickly changed the strategy to an aggressive acquisition-driven high-teens targeted top-line growth, levering the company's pristine balance sheet.

Let me provide some color on the new holdings.

Manhattan Associates is a leading vertical software provider focused on complex supply chain and omni-channel solutions. The company helps customers reduce inventory, optimize warehouse operations and drive other supply chain efficiencies. Many of Manhattan's customers are retailers who are certainly facing multiple challenges in their business currently. While Manhattan's software enables them to be more competitive, some are delaying major software installations. We view these issues as transitory in nature. In fact, we like finding new ideas in segments under pressure, looking for names that are better protected or even in a longer term position to benefit from those issues. We believe that we are still in early stages of a broad global supply chain technology roll-out both within the company's core retail customer space and adjacent markets. Importantly, once in place, Manhattan's mission-critical software becomes the backbone of a client's supply chain ecosystem, making any attempts to dislodge it both extremely costly and highly disruptive. This "stickiness" coupled with modest capital expenditure requirements creates an attractive business model which is reflected in the company's strong profitability, solid free-cash-flow generation and pristine balance sheet.

MGM Growth Properties is a real estate investment trust which was formed by MGM Resorts to acquire and hold eleven casino properties that MGM operates. A number of aspects of this industry serve as important entry barriers helping protect the company from competition. First, at an individual property level, gaming licenses are heavily regulated and are difficult to obtain. In particular, the Las Vegas Strip continues to see limited new supply of rooms despite steady growth in visitor traffic. Secondly, MGM Growth collects rent under a master lease guaranteed by MGM. In other words, even if these properties were to struggle, MGM is obligated to pay the full rent because it has pledged all of its assets to support the lease. Lastly, due to both historic and regulatory reasons, MGM Growth has only one other REIT competitor that has similar experience and licensing credentials.

In summary, we are very satisfied with the portfolio's current positioning both in absolute terms and versus the Russell 2000 Value benchmark on all of the quality, growth and value metrics that we monitor and manage to. Five-year average return on equity for our companies stands at an impressive 22.9 percent versus 7.4 percent for the Russell 2000 Value Index. Importantly, it is derived from solid underleveraged balance sheets with debt-to-EBITDA ratio for our companies of less than 2 times versus over 7 times for the Index. Diluted earnings per share compounded annual growth for the past 10 years (which includes the Great Recession) for us stands at a solid 11.4 percent—more than twice that of the Index, and our companies have grown quarterly cash dividends per share at a compounded annual growth rate of 9.4 percent over the past 10 years versus 2.7 percent for the benchmark.

We remain fully committed to our high-quality discipline and focused on the long-term outlook for our companies and our portfolio. We also remain confident that investing in high-quality businesses will yield superior risk-adjusted returns over the longer term. In fact, our discipline of being a high-quality investor has been proven through our long-term alpha generation.

Thank you again for taking time to listen to this recording today, and as always, if there are any questions or comments, please do not hesitate to reach out to us.