KayneCast

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Fourth 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 fourth quarter and full year of 2017, discuss the drivers of performance, talk about new names and sells in the portfolio and conclude with a market outlook.

The fourth quarter of 2017 was again positive for equities with the S&P 500 returning 6.6 percent in the quarter. Smaller stocks underperformed their larger brethren, with the Russell 2000 Index increasing 3.3 percent—a slight deceleration from last quarter. When dissecting the quarter by month for the Russell 2000 Index: October was up just under 1 percent, November was up 2.9 percent, and lastly, December was down slightly at negative 0.4 percent.

The sectors that drove the performance in the quarter were consumer staples, energy and consumer discretionary. On the downside: REITS, utilities and technology all lagged. 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, with high betas, and higher debt on their balance sheet all outperformed their counterparts on each of those metrics. Our Small Cap Core portfolio outperformed the Russell 2000 Index by about 700 basis points in the fourth quarter. Superior stock selection in financials, producer durables and technology drove the outperformance and was enough to offset the market headwind of lower quality doing well.

Focusing more on the year 2017. In a bit of a reversal, small caps underperformed the larger market with the Russell 2000 Index growing over 14.6 percent in 2017. The S&P 500 Index was up 21.8 percent for the year and—by the way, for the first time in the history of that index—there was not one negative return month in 2017 for the S&P 500.

When looking at the sectors that did well in 2017, they were health care, producer durables and technology. The sectors that lagged were energy, consumer staples and REITs. The market overall in 2017 was decidedly lower quality in nature. Companies with high debt, high betas and low S&P stock rankings performed well below their counterparts. Despite these headwinds, the Kayne Anderson Rudnick Small Cap Core portfolio outperformed the Russell 2000 Index by over 2000 basis points. Stock selection ruled the year and was the main reason for the outperformance. Selection in technology, financials and consumer discretionary stood out.

We had a few names that drove some of our outperformance for the year: Autohome, NVR and Primerica. All of these stocks were up at least 40 percent for the year. We've talked about Autohome and Primerica in the past, so let me go into a little more detail on NVR. NVR is engaged in the construction and sale of single-family detached homes, townhomes and condominiums in markets throughout the U.S. Unlike most homebuilders, NVR does not purchase and develop raw lots of land. Instead, the company uses purchase options on developed land, which significantly reduces its financial leverage and operational risk. Shares increased throughout the year as the company reported several quarters of better-than-expected revenue and earnings growth. NVR continues to benefit from the ongoing—but slow—recovery in housing. While we expect opportunities remain for further increases in revenues and earnings, we have sold our position as the market cap has now surpassed 14 billion dollars and is no longer appropriate for a small cap strategy. We remain admirers of the business and hope to find other investment ideas that will prove as rewarding as NVR to our investors.

The companies that lagged the most in the year were Shutterstock, Dril-Quip and Abaxis. I've discussed Abaxis and Shutterstock in the past, so let me say a few words on Dril-Quip. Dril-Quip designs, manufactures, sells and services engineered offshore drilling and production equipment, including subsea and surface wellheads and production trees, subsea control systems and manifolds, and wellhead connectors. Shares lagged driven by continuous weakness in deepwater drilling activity. Our view of the company's long-term market positioning remains intact, however. We continue to believe that Dril-Quip is better protected both as a "best of breed" mission-critical equipment supplier and a low-cost manufacturer. Dril-Quip has a long-term track record of disciplined capital allocation, and the company's balance sheet remains pristine with plenty of cash and no debt. With the operating environment improving and the shares attractively valued, we increased our position in the company in early Q4 2017.

Now let's talk about any new names or sells in the portfolio in the quarter. We actually had no new buys and two outright sells in the quarter. I already told you about NVR, but the other was Polaris.

In regards to Polaris, investors were concerned about increasing competitive threats in the important side-by-side product category, which we viewed as a natural development given the lack of effective competition previously. Polaris had successfully competed in its other vehicle categories for many years, which provided us sufficient confidence to purchase a small position in this high-quality company. Shares have remained weak, however, with persistently challenging market conditions exacerbated by a series of sizeable product recalls, including that of Polaris' marquee RZR Turbo side-by-side product, allowing the rival Can-Am Maverick X3 vehicle to take some share away from the company and resulting in elevated warranty and aggressive promotional activity expenditures, hampering margins and forcing management to back away from longer-term financial targets. While the company's profitability, balance sheet and free-cash-flow generation ability remain solid, we are concerned that profitability is unlikely to recover to prior peak levels given the narrowed competitive gap in the higher margin side-by-sides product line. With these considerations in mind, we have decided to exit our small position in Polaris to fund the purchase of another consumer discretionary name that, we believe, offers a higher risk-adjusted return opportunity.

Let's talk about our market outlook. Q4 of 2017 was a continuation of Q3 as the market sustained its lower-quality bias which parlayed itself in to the overall 2017 results. 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. Stock picking matters this year especially, but we believe it matters always. 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 metrics. For example, return on equity in this portfolio of 27.4 percent compares to 10 percent of that of the Russell 2000 Index. Debt-EBITDA of 1.5 times versus 6.6 times that of the index. The earnings-per-share growth in our portfolio over the last 10 years: 14 percent versus 7 percent for the index. Price-to-earnings the trailing twelve months for us of 31.8 is at a discount to the 40.7 for that of 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.