KayneCast
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Episode 40

Second Quarter 2016 Review of the Small Cap Quality Value Portfolio

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Hello, this is Craig Stone, Portfolio Manager for Kayne Anderson Rudnick's Small Cap Quality Value strategy. Today, I am here to offer a second quarter 2016 review and highlight some of the portfolio holding changes and stocks that have both contributed positively as well as negatively to the overall performance.

It was certainly an interesting end to the second quarter. Recall that on June 23rd, the citizens of Great Britain narrowly decided that the best course for the future of the country was to exit the European Union. This surprising outcome was not what the majority of experts and commentators had predicted. While everyone did expect a close vote, it was still expected that Britain would remain in the European Union.

Once again, we are all reminded that no one—no matter how much technology, insight, or supposed expert views—can accurately predict the future, just as we cannot predict the stock market from day-to-day or week-to-week.

Speaking of stock market predictions, on June 23rd as the realization that Brexit was happening, international stock markets around the world took it hard. We saw milder effects here in the U.S. initially. There was some carry over the next trading day in the U.S. but then that was it. In fact, in the subsequent one week's trading time, the U.S. market pretty much recovered all of the Brexit effect and more. And more recently we have seen most of the major U.S. indices hit 52-week highs and even the British markets have completely recovered and [are] hitting new highs as well.

Does that mean that the Brexit vote was a non-event? No. But the majority of true impact from exiting the EU will be felt over the next few years and not immediately tomorrow. And over that future period, there is so much unknown of what is or could happen since this would be the first exit from the EU since its formation.

So how does this affect investors here in the U.S.? Well, it probably means that the Federal Reserve and Central Banks around the world will keep interest rates low and for longer time periods. But again, that would be our best estimate, but no one truly knows. Only time will tell.

Let's focus on what we know and can control. And that is buying high-quality businesses and holding them for the long duration.

Our Small Cap Quality Value Portfolio outperformed the Russell 2000 Value benchmark in the quarter. From a sector perspective, performance was driven by strong stock selection in the consumer-staples and financial-services sectors. We saw unfavorable stock selection in the materials and producer-durables sectors.

The two stocks that contributed most to performance during the quarter were National Beverage and Primerica. Shares of National Beverage (with the ticker of FIZZ – quite clever), continued to perform well due to its sparkling-water brand, LaCroix. The consumer's shift away from carbonated soft drink into sparkling water may have even accelerated, and FIZZ is benefiting from that trend.

Primerica had been an underperforming stock previously but saw its fortune turnaround with the diminished regulatory concerns and solid operating results.

The two stocks that contributed the least in the quarter were Cheesecake Factory and Syntel. Both of these stocks had minor issues in the quarter, however, there were no fundamental changes or any structural issues to its business to warrant long-term worry. We are still holders of both of these stocks.

We also made one new purchase and three sales from the portfolio during the quarter. We bought Thor Industries, the second largest manufacturer of recreational vehicles in the U.S. Large scale allows the company to enjoy significant purchasing power with its suppliers that translates into meaningful advantages in cost of materials over smaller competitors. Technically, this is not a new name for the portfolio. We actually had previously owned the stock and sold it back in 2014.

Also in the quarter, we exited out of our position in Computer Services, First Cash Financial, and Questar.

We exited out of Computer Services as we saw the company's core marketplace of smaller financial institutions suffer from the ongoing industry consolidation driven by rapidly rising regulatory compliance costs.

For First Cash, while we continue to admire the company's positioning in the growing Mexican market, we saw the company's U.S. business struggle and, we believe, [this] was more structural than cyclical in nature.

Lastly, we sold our position in Questar after the company announced its acquisition by Dominion Resources (another utility but in a different geography).

I am not going to give a market outlook here today as our Chief Investment Officer, Doug Foreman, has a separate podcast which specifically addresses the market environment.

But what I will say in closing is that the Brexit vote should be a reminder to all of us that trying to predict near-term events with absolute certainy is futile. Trying to predict the short-term movements of the stock market should prove equally futile. What we are certain of is that buying high-quality businesses and owning them for the long term have proved to be rewarding. It has been nearly 25 years since we began our first small-cap portfolio and the alpha generation we have created should be an ample proof statement.