KayneCast
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Episode 10

Third Quarter 2014 Review of the Small Cap Core Portfolio

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Hello, I'm 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 2014, discuss the drivers of performance, talk about new names in the portfolio, and conclude with a market outlook.

While for the third quarter in a row small caps in general underperformed larger stocks, clearly there was a more downside skew in the smaller names than we have seen. While the S&P 500 returned a little over 1% in the quarter, their small cap brethren were down over 7%.

The quarter's monthly activity for the Russell 2000 Index was once again volatile, as July was down 6%, August was up 5%, and September went right back down again, falling 6%. Overall, the Russell 2000 finished lower by over 7% for the quarter. The sectors that drove the performance to the downside were energy, financial services, and utilities. It is interesting to note that no sector was positive for the quarter.

So what types of businesses drove the weakness in the market? Unlike what we have seen in the past few years, lower-quality names have reversed their course of leading the market higher and are now leading the market lower. Companies that have lower S&P stock rankings, high betas, and high leverage on their balance sheets all underperformed their counterparts—where we invest—on each of those metrics. One data point that demonstrates this; stocks with betas over 2 were down over 9% in the quarter, while those in the 0.5 to 1 range—where we have over 65% of our portfolio—were down 5%, a 400 basis point advantage for high quality.

Given the shift in the market to a more high-quality bias, our Small Cap Core portfolio outperformed the Russell 2000 Index by about 4% in the quarter. This should come as no surprise to those who know us as investors of high-quality businesses. We once again held up much better when the market was weak in July and September—which you should expect from us—and we didn't lag too far behind when the market was strong in August.

We had a few names that drove our outperformance in the quarter; MarketAxess, Abaxis, and Landstar System. All of these stocks were up at least 13% in the quarter. Let me go into a little more detail on each. MarketAxess is a name that we recently purchased in the portfolio. They are an operator of a leading electronic trading platform for high-grade corporate bonds. The shares rose as the company's financial results and market share continue to be healthy despite sluggish overall market volumes.

Abaxis is another name we spoke about last quarter. They are a manufacturer of blood diagnostic devices sold through both medical and veterinarian channels that provide blood-test results in doctors' offices in 12 to 13 minutes versus a traditional lab that comes back days later. Abaxis once again saw its shares drive higher in the quarter as more doctors adopt their products. Also, a major competitor announced it was going to take its distribution direct, thus potentially opening up new channels of growth for Abaxis.

Landstar System, an asset-light provider of freight transportation services, has been experiencing improving pricing power amid firming customer demand which has led to healthy revenue and earnings growth.

Now let's talk about a few stocks that lagged in the quarter, those being MRC Global and Copart. MRC Global primarily distributes pipes, values, and fittings to the global energy industry and has about 20% market share, which results in significant scale advantages. During the third quarter, MRC reported significant top-line growth that was partially driven by a lower-margin product. This negative product mix shift was moderately disappointing. Yet it should reverse itself in future quarters. MRC continues to have dominant share in the industry, and its scale advantage should lead to healthy returns and steady free-cash-flow generation.

The other stock was Copart. Copart is a provider of salvage vehicle auction services. The company benefits from strong network effects, as both buyers and sellers want a deep and fair auto auction market. The stock declined in the quarter, as margins are not recovering as quickly as some had expected after merger integration activity and ERP software implementation costs. However, margins are gradually improving, and despite a few setbacks, we continue to expect normalization going forward.

We added one new name in the portfolio this quarter, that being Primerica. We did have two businesses we sold in the same time frame; The Advisory Board and Hittite Microwave.

Talking a little about Primerica, they are engaged in the distribution of financial products to middle-income households. The company utilizes a multi-level marketing sales structure to sell various products including term life insurance, mutual funds, annuities, and even prepaid legal services. Primerica possesses a scale advantage in its sales force given that larger competitors deem the low dollar amounts of policies and funds as uneconomical, and this allows Primerica to invest more dollars to recruit and train new salespeople. This structural cost advantage translates into solid returns on equity and substantial free cash flow that has been used to buy back shares and pay an ongoing dividend.

The two stocks we sold in the quarter were Hittite Microwave and The Advisory Board. Hittite announced back in early June that it would be acquired by Analog Devices at a 29% premium to the day's prior close. Since we have no intention of owning Analog Devices given its large market cap, we sold our entire position in the quarter.

The other company we sold was The Advisory Board, a provider of best practices research and tools to the health-care and now education markets. The company has transitioned its business model from mainly a provider of best practices research and services for the health-care community—that we believe has significant barriers to entry and a solid network effect—to a software-based, data-analytics focused company that is expanding their health-care offering into new areas, such as education. We believe the profitability, returns, and overall competitive moat that were a strong part of our original investment thesis have been impaired for the long-term by the new direction of the company. This reiterates our general thesis that when a business undergoes a fundamental change in their business model, this could be an impetus for us to sell our shares.

Let's take a look at the market outlook. As I said earlier, after several quarters and years of observing a low-quality tailwind in equities, we have been experiencing a reversion to high quality as the economy continues to have some hurdles to overcome to improve the sluggish nature of this current "recovery." We believe a reversion to the mean in returns is under way and appropriate as interest rates seep back up, and the current geo-political environment creates volatility and an unsettling future for global growth rates.

Putting this all together, we believe the market is in the process of adjusting for these factors. 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 those types of metrics. For example, return on equity in this portfolio of 20% versus 9.8% for the Index, debt-to-EBITDA of 0.8 versus 4.5 for the Index. Our companies have less debt on the balance sheet. Earnings-per-share growth the last 10 years; 11% versus 6% for the Index. P/E the last trailing 12 months; 23 versus 32. So we are finding those high-quality businesses at a discount.

This is why we favor our high-quality bias over the long term. That is where we invest. That is our history, and our future. Thank you for your time, interest, and continued trust and confidence.

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