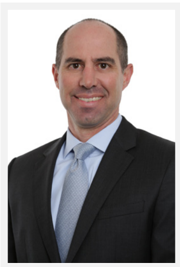

Episode 13

Third Quarter 2014 Review of the Small Cap Quality Select Portfolio

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Hi, this is Todd Beiley, manager of the Small Cap Quality Select portfolio here at Kayne Anderson Rudnick. Today I'm going to review the third quarter of 2014. I'll make some comments about the general market and then discuss our portfolio. First, the numbers.

Small Cap Quality Select declined 2.1%, net of fees, in the third quarter of 2014. This compares to a decline of 7.4% in the Russell 2000. Year to date, our portfolio has declined 11.8% while the Russell 2000 has declined 4.4%. Over the trailing five years, our portfolio has increased approximately 18% on average annually, net of fees, while the Russell 2000 has increased about 14%.

So, despite a decline so far in 2014, the small cap market—which Russell defines as companies with market valuations below $7 billion—has provided a very healthy return of about 14% annually since 2009. Over the past seven years, which encompasses the financial crisis of 2008, the annualized return has been about 6%, which is a rate closer to the long-term average and an amount I believe will more closely approximate future average annual returns. Of course, each individual year will vary, possibly significantly, from that average.

In a reversal from 2013, small-cap stocks have lagged large stocks this year. Measured by the S&P 500, large-cap stocks have returned about 8% thus far in 2014, outpacing the 4% decline in the Russell 2000. In 2013, the Russell 2000 gained just about 39%, beating the 32% of the S&P 500. I'm not sure what, if anything, there is to read into these variations in returns, but you should know that the reason I focus my investment efforts on stocks of smaller companies is not that I believe they will outperform large companies as a group, but rather because there is a better chance of finding favorable individual situations, because there are many more companies and fewer people looking.

Turning to our portfolio, our position in Chef's Warehouse has been the cause of the portfolio's decline in value this year.
Let me provide some perspective on this holding.

We first purchased Chef's in 2012 at prices ranging from $13 to $18 per share. Our thesis was, and continues to be, that as the largest independent distributor of specialty foods to restaurants in the U.S., the company benefits from sizeable scale advantages over the many small specialty food distributors. This advantage is evidenced by consistent market-share gains and healthy profitability the company has enjoyed over many years since its founding in 1985.

Chefs' can purchase product at lower prices due to its higher volume and has a lower operating cost per delivery due to its greater number of customer drops per route. This enables the company to provide better customer service through more frequent deliveries, smaller order sizes, and later order cut-off times, while maintaining higher profitability levels than its smaller competitors.

Meanwhile, the food distribution industry entails low risk of obsolescence and enjoys relatively persistent demand.
After our initial purchase, the price increased to a high of $29 at the end of 2013, as the business progressed and investors became enthused.

2014 has been a different story. First, severe winter weather in the Northeast—which is Chef's primary market—hurt results at the beginning of the year. Also, management has increased spending on technology, regional sales managers, and warehouse expansions, to support future growth. Additionally, rapid inflation in beef prices has hurt gross profits at a recently acquired beef company because it takes time for a distributor to pass abrupt price inflation on to its customers.

These forces have pressured current profitability and caused the stock to fall back to about $16 currently. I believe the fundamental aspects of our original investment thesis remain intact and that the company's profitability will improve over time as the higher fixed costs are absorbed by increasing revenue, and as higher product prices are passed on to customers. Although there have been several bumps in the road, organic growth in revenue, case volume, deliveries, and new customers continues to be very healthy while gross margins have remained relatively stable.

Chef's remains our largest holding as I believe we will earn an attractive return on this investment over the coming years.

At the portfolio level, we made only minor changes to our holdings during the third quarter. We added to our position in Chef's as the price declined and, to fund that purchase, we reduced our holdings in MercadoLibre and CDW.

Our holdings remain unchanged in name from the previous quarter. As of September 30, they were, in order of magnitude, The Chef's Warehouse, NVE, UFP Technologies, Primerica, MercadoLibre, and CDW.

We appreciate the trust you have placed in us by allowing us to oversee your investment and will continue to manage your capital with diligence.

This concludes my comments. Thank you for listening.