KayneCast

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Episode 16

Fourth Quarter 2014 Review of the Small Cap Core Portfolio

Jon Christensen, CFA
Portfolio Manager & Senior Research Analyst

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 fourth quarter and full year in 2014, discuss the drivers of performance, talk about new names in the portfolio, and conclude with a market outlook.

After seeing weakness in the third quarter with small caps being down about 7%, the fourth quarter of 2014 was a different story, with the Russell Index rebounding almost 10%. The sectors that drove the performance in the quarter were healthcare, utilities, and consumer discretionary. On the downside, after being the leading sector in Q3, energy was down an astounding 35% in the quarter. Of course this was induced by the meltdown we have seen in global oil prices.

So what types of businesses did drive the market? Companies that have higher S&P stock rankings, low betas, and little leverage on their balance sheets all outperformed their counterparts on each of those metrics. While the quarter did have a high-quality bias, it was not that significant. For example, health-care was a sector that led the market nicely, but low-quality biotechs outperformed higher-quality health-care stocks by about a 2 to 1 margin.

Our Small Cap Core portfolio performed in-line with the Russell 2000 index. Given that the market was up almost 10% on an absolute basis, we are pleased that we're able to keep up with this strong market. Focusing more on the year 2014, it was definitely the year for large caps. While the Russell 2000 Index grew 5% in 2014—after two years of solid growth—the S&P 500 index was up almost 14%.

When looking at the sectors that drove the market in 2014, they were health-care, consumer staples, and utilities. Energy was down over 39% for the year, again driven by the decline in oil prices. Focusing on small caps, there was a skew toward high-quality stocks, including those with high S&P stock rankings and low betas. However, it again was not as formidable since some low-quality characteristics such as high-leveraged companies were able to outperform their counterparts. Given the high-quality bias in the market, combined with a benign and even lessening Fed presence, companies have to prove themselves on their own merits in this environment. That is where we believe we can add value.

As a result, we outperformed the Russell 2000 by over 2% in 2014. We had a few names that drove some of our outperformance for the year; MarketAxess, Abaxis, and Hittite Microwave. All of these stocks were up at least 25% in the year.

We've talked about MarketAxess in the past. So let me talk in a little more detail about Abaxis. Abaxis is a manufacturer of blood-diagnostic devices sold through both veterinarian and medical channels. Abaxis saw its shares drive higher in the past year as the company's new third-party distributors are seeing improved sales after a year of inventory disconnect that led to weaker top-line results in the previous year. The company's systems are being adopted in vet clinics and labs, as well as in the human medical market, with retail opportunities such as drug stores being a another leg of growth potentially.

Among the stocks that lagged for the year [was] Hibbett Sports. Hibbett operates sporting goods stores in small to mid-sized markets predominantly in the Southeast, Southwest, and Midwest regions. Its stores offer a broad assortment of quality athletic equipment, footwear, and apparel with strong customer service. In 2014, Hibbett's operating results were challenged by sluggish traffic and sales growth in addition to higher investment spending. The company is laying the early foundation for omni-channel expansion, beginning first with the ability to save a sale in the store. The company plans to be able to fulfill these lost sales in fiscal 2015, with additional spend to enhance its online presence. Management has not yet stated if it will be a full omni-channel retailer. However, the incremental investments should improve productivity in stores while making inventory management more efficient.

We added one new name in the portfolio recently, that being Artisan Partners Asset Management. They are an asset manager—that attracts high-quality professionals—that is conducive to creating good long-term investment results. [Having] autonomous investment teams minimizes non-investment related burdens and fosters an entrepreneurial approach and owner-oriented mindset. We believe these are unique in the industry and not easily replicated by other managers. Their business is highly profitable, with operating margins over 45%, operating asset turnover at 9 times, and an underleveraged balance sheet.

The three stocks we sold in the quarter were Techne, Federated Investors, and MRC Global. Techne, we believe, is facing structural headwinds in their proteins business as they pursue an M&A strategy to grow their business that we believe could permanently impair returns on capital and margins. Federated has evolved from being a pioneer in the money market industry to having a greater mix of equity funds in their offerings. This combined with the core money market business seeing greater regulatory pressure has led us to sell our entire position. Lastly, we sold MRC Global, a provider of pipes, fittings, and valves to the energy industry. Given the large decline in oil prices, we have seen companies such as MRC see large declines in their stock price in anticipation of future demand tailing off. While we still believe that MRC has a valuable scale purchase advantage as a large distributor, we sold our position and shifted funds to another name that we believe has better overall profitability and durability during this time and view the swap as upgrading the quality of the portfolio overall.

Let's talk about the market outlook. After several years of observing low-quality tailwinds 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 sustainable competitive advantages, outgrowing their markets, and that have 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. The return on equity in this portfolio is 21.5% versus 10% for the index. This really says that in a market of commodity businesses we own proprietary businesses. Debt to EBITDA of 0.9x versus 5.7x for the index [shows] our companies have a lot less leverage on their balance sheets. Earnings Per Share Growth the last 10 years? 12.5% versus 6% for the index. Remember this includes the recession as well as the recovery. And this portfolio is trading at a 5 multiple discount to 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.