KayneCast

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Episode 27

Third Quarter 2015 Review of the Small Cap Core Portfolio

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Hi, 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 in 2015, discuss the drivers of performance, talk about new names and sales in the portfolio, and conclude with a market outlook.

After last quarter's Russell 2000 Index rise of a miniscule 0.4 percent, the third quarter of 2015 was much more active, with the Russell falling almost 12 percent. This was in comparison to the 6.4 percent loss for the S&P 500. In general, value outperformed core and growth investment styles, a reversal from last quarter.

The sectors that outperformed in this weak market were utilities, consumer staples, and financials. On the even weaker side, energy, materials, and health care all underperformed. It should be noted that no sector was positive in the quarter.

So what types of businesses did hold up in this market? It was a clear highway this quarter in favor of higher quality businesses. Companies with high S&P stock rankings, low debt on the balance sheet, and low betas all outperformed their counterparts. It is worth pointing out that unlike last quarter, health care was a significant underperformer, reversing several quarters in a row of superior results. Recall that biotechs and pharma make up about 8 percent of the entire Russell 2000 Index. In Q3, health care was down over 17 percent versus down 12 percent for the Russell [2000] Index overall. Of particular note, 5 of the bottom 10 contributors—or detractors—to the Russell 2000 Index in Q3 were biotech firms. Once again, a reversal of what we saw last quarter.

Our Small Cap Core Portfolio outperformed the Russell 2000 Index by over 300 basis points in the third quarter of 2015. Given the issues discussed previously—in particular, the high-quality tailwinds—we believe the performance on this basis is understandable. The highest contributors for the quarter were: CDW Corp, NVR, and Jack Henry. All of these stocks were up at least 8 percent in the quarter.

I'll say a few words about CDW, which provides information technology solutions for business, government, education, and health care customers. Its offerings range from discrete hardware and software products to integrated IT solutions such as mobility, security, data-center optimization, cloud computing, and collaboration. The company reported very healthy results across all product lines. Strong results were led by growth in the government segment. The company announced its intention to purchase the remaining shares in Kelway in Europe. After meeting with the company's management this quarter, we are confident this acquisition will have a positive impact on the company's competitive position and support healthy growth longer term.

Among the stocks that lagged in the quarter were Shutterstock, Artisan Partners, and Autohome. I'll say a few words about Autohome. Autohome is a new company we added to the portfolio this quarter and they are a holding company for several Chinese-based websites focused on the consumer-automotive industry. Users of Autohome's websites can research professional and user-generated reviews of private-passenger vehicles sold in China. Users can also search local car-dealer inventory and participate in car-buying promotions. Macro concerns regarding slowing new car sales and a weakening Chinese consumer have pushed the shares of Autohome sharply lower. In addition, the decision by management to grow the transaction side of its business at the expense of near-term margins has created additional pressure on the share price. However, Autohome's core business metrics are healthy (70 percent growth in Q2) and the longer term potential of the Chinese car market is significant, so we remain owners of the business.

We added two new names in the portfolio this quarter, those being Autohome, which I spoke about before, and HFF. HFF is a broker in the U.S. commercial real estate market. Its professionals place debt, raise equity capital, and provide transaction advice to buyers and sellers of commercial real estate. Think of HFF as an investment bank focused exclusively on commercial real estate. The company has built a well-regarded reputation and its culture and compensation structure attract high-performing transaction professionals. HFF is a pure-play real estate advisory firm and does not offer property management and investment management services, which can create perceived conflicts of interest in the eyes of clients. This simplified offering allows HFF to differentiate itself from competitors and avoid the high fixed costs needed to support those non-advisory other lines of business. High-performing transaction professionals are attracted to HFF's "conflict free" model because it a) removes conflicts of which should help win deals and b) the high payout ratio allows top performers to make more money than working at another firm. This compensation structure and culture would be difficult to replicate at an existing diversified real estate services firm. Since the depth of the financial crisis in 2009, revenues have grown at a 5-year CAGR of 41 percent. Taking a longer term view, revenues have grown at a 10-year CAGR of 11 percent. This growth has been driven by share gains as the company recruits more transaction professionals. Excluding the financial crisis of 2008 and 2009, EBITDA margins have averaged 20 percent. HFF is a people driven business, so most of its costs are variable. Therefore, despite the expectation for continued revenue growth, margin expansion going forward will not be that meaningful.

We sold three names in the quarter, those being Hibbett Sports, Cohen & Steers, and Lincoln Electric. Hibbett was sold due to what we believe is a deterioration in their business model as foot traffic has declined and the company has ramped up spending for its future e-commerce initiatives. We believe this process could be long, costly, and misplaced as it places Hibbett more competitively in front of larger players, such as Amazon and Dick's Sporting Goods. We sold Cohen & Steers due to ongoing net outflows the company has seen as well as potential REIT weakness as interest rates rise over time. Lastly, Lincoln Electric was sold due to valuation of the shares combined with a small weight, which led us to sell the position and reallocate to other ideas with more compelling risk-reward metrics.

Let's take a look at our market outlook. We continue to see the low-quality headwind for us evolve into a high-quality tailwind for our portfolio. After several years of observing a low-quality tailwind in equities, we have been experiencing that reversion 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 underway 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 longer term, you want to own high-quality businesses that have sustainable competitive advantages, outgrow their markets, have low debt and strong free cash flow, that trade at discount to multiples of the greater market.

Our portfolio continues to look favorable versus the benchmark on these types of metrics. The return on equity in this portfolio at the end of the quarter was 25 percent versus 10.7 percent for the Index, Debt to EBITDA of 1.1 times versus 4.9 times that of the Index, earnings-per-share growth in the last 10 years for this portfolio of almost 10 percent versus 5.7 for the Index, and the P/E on a trailing 12-month basis in this portfolio of 20.8 versus that of 30.3 for the Russell 2000 Index.

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