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Episode 28

Third Quarter 2015 Review of the Small Cap Quality Value Portfolio

Craig Stone
Portfolio Manager & Senior Research Analyst

Hello, this is Craig Stone, Portfolio Manager at Kayne Anderson Rudnick. Today I will be making some brief comments on the third quarter equity market along with some highlights of our Small Cap Quality Value Portfolio.

This past quarter was very tough for the overall equity market. Investors' worries regarding global economics, particularly China, worries about the Federal Reserve's hold-off on interest rate hikes, and worries about the growth of corporate profitability weighed on the overall equity market.

Stock market returns declined across the board, erasing the year-to-date gains in virtually all of the major market indexes. Large-capitalization stocks, as measured by the S&P 500 Index, declined 6.44 percent while the Russell 2000 Value Index dropped 10.73 percent in the quarter.

Additionally, during the quarter, it was evident that the riskier assets had the lowest returns. Energy and materials continued to be the weakest sectors, but even health care showed some signs of weakness in the quarter. Risk was also evident in the high-yield market as the high-yield credit spreads for all sectors rose sharply. In fact, every sector in the Russell 2000 Value Index had negative returns in the third quarter. Even the typically defensive stalwarts in consumer staples and utilities sectors had negative returns as well.

So how did our Small Cap Quality Value Portfolio fare in the third quarter? Well, for those investors who know us, we have always had good capital preservation and downside protection stemming from our investment philosophy of owning high-quality businesses. And owning such high-quality investments served us well in the quarter.

For the third quarter, high return-on-equity companies outperformed low return-on-equity stocks. Companies with lower debt-to-capital levels protected better than companies with high debt levels. Higher beta stocks underperformed lower beta stocks. All of these attributes highlight the attraction of owning high-quality businesses during a declining market.

In this environment, we have seen our portfolio outperform in the quarter, outperform year-to-date, and outperform over the past twelve months relative to the Russell 2000 Value Index.

For the quarter, from a sector standpoint, we had good stock selection in consumer staples and producer durables while stock selection in utilities and health care detracted from performance.

The companies that contributed most to performance during the quarter were National Beverage and Heartland Payment Systems. National Beverage develops, manufactures, and markets flavored beverages for sale across the country. Its beverage portfolio includes soft drinks, energy drinks, juices, teas, sparkling waters, and enhanced beverages. While FIZZ's carbonated soft drink brands have been weak like the rest of the industry, these declines have been more than offset by growth in its sparkling water portfolio, particularly the LaCroix brand. Revenue and earnings were up sharply in the most recent quarter, driven by record growth in the sparkling water brand. These strong results, which we expect to continue, coupled with a cash-rich balance sheet are reasons for our continued ownership of the business.

Heartland Payment Systems provides bankcard processing services to small and mid-size merchants in the United States. Shares continued to perform strongly driven by the company's reports of solid operating results. Importantly, Heartland continues to be a solid free-cash-flow generator, returning excess cash to shareholders in the form of cash dividends and opportunistic share repurchases.

On the other hand, the companies that contributed least to performance during the quarter were Corporate Executive Board and Artisan Partners. First, CEB provides best business practices research and talent management tools to business executives and professionals worldwide. With 100% of the Fortune 100 as customers, CEB benefits from a substantial network effect. The stock was weak in the quarter as attrition of junior employees kept senior employees from being out in the field selling CEB products. To remedy the situation, the company recently hired more than 50 junior employees to support senior sales leaders. Despite this short-term slowdown, we remain confident in CEB's ability to expand both its product set and its customer base.

The second stock that detracted in the quarter was Artisan Partners, a multi-strategy asset manager with over $100 billion in assets under management. Artisan Partners has seen persistent outflows within its U.S. Value team as well as a general decline in global equity markets, which have led to the weakness in its stock price. The company's unique business model still provides long-term growth opportunities both for existing teams and newly created ones. We believe that management's practice of distributing earnings is also a long-term positive.

Now normally I do not try to say much about near-term market outlook given that we are long-term investors with a fundamental bottom-up process and our investment decisions are not driven by economic factors. However, given the sharp equity decline in the third quarter and for what it is worth, I would like to share a bit of our outlook with you.

Household net worth continues to hit a new highs. Consumer confidence is back to 2007 levels. The labor market continues to improve, which is a key indicator for the Fed and its willingness to raise interest rates. Corporate cash is still at an all-time high, leading to share buybacks, dividend increases, and acquisitions. Corporate earnings and revenues continue to grow in constant currency and, thus far, historically high operating margins are holding.

We believe that the recent global headlines and stock actions in the quarter are highly unlikely to lead to a full-fledged bear market or global recession. We believe this quarter will more than likely prove to be a painful correction similar to that experienced in 2011 rather than the beginning of a global crisis which we experienced in 2007. Equity valuations remain reasonable by historical measures, both at absolute levels and particularly relative to interest rates.

However, in the near term, equity markets are likely to stay volatile through the end of the year, but many individual stocks look attractive to us over a three-to-five year time horizon. We believe long-term investors like ourselves will be rewarded from here over time. As always, we aim to invest in high-quality businesses which can do well in both good and bad times.

Thank you for listening to this recording and as always we welcome any questions or comments you may have.