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Episode 2

2013 Review of the Small Cap Core Portfolio

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Hi there, my name is Jon Christensen. I'm the Co-Portfolio Manager on the Kayne Anderson Rudnick Small Cap Core Portfolio. Today I would like to review with you our portfolio for 2013 with a general market overview to start, drivers of performance, we'll then talk about some new names in the portfolio, our portfolio characteristics, and then we'll conclude with an overall market outlook.

So let's talk about 2013 overall. The market in 2013 was considered strong by many, robust by the rest. Signs of an improving economy drove the overall stock market, with small caps mostly being the main beneficiary by outperforming the larger S&P 500 by over 6% for the year. The Russell 2000 Index was up over 38% in 2013, on top of a 16% return in 2012. The Russell has now delivered the highest five-year rolling return in over 16 years. Lastly, the Russell 2000 has had the fourth best calendar return in the history of the index, so overall indeed, we can agree that it was a very strong year for small caps.

In 2013, the sectors that really drove the performance were health care, which was up over 51% for the year; consumer staples, up over 47%; and consumer discretionary, up almost 45% for the year. On the lower end, utilities were the lowest performing sector, but still increased almost 22% for the year. This just really gives you an indication on how strong the overall market really was in 2013.

So let's talk about businesses—the ones that really benefited the most in this environment. So the companies whose stocks had high betas, high PEs, and high debt on their balance sheet outperformed their counterparts on each of those metrics. Case in point, stocks with PEs in the 30x-45x range were up over 49% in 2013, while those in the 14x-16x range were up 23%, huge difference there in performance. Stocks with betas over 2.0 were up 42%, while those in the 0.5-1.0 beta range (where we have over 50% of our portfolio) were up 37%. All in all, I think we can confidently determine the character of the market in 2013 was one of lower quality versus higher quality.

So look at the drivers of the performance that we had in the year. So overall, after reviewing what we have talked about before, that low-quality factor that really was driving the market, our portfolio underperformed. We had only one stock that was actually negative for the year and that was National Interstate (Ticker NATL). NATL is a specialty property and casualty insurance company that sells traditional and alternative insurance products with a focus on the transportation industry. This was one of the few (actually only stock that we had for the year that was negative), and the company really suffered during the year as it saw its combined ratio actually increase. The combined ratio for an insurance company is an indication of profitability as it divides incurred losses plus expenses by net premiums earned. Ergo, the lower the ratio, the better. This is a company when we bought it had about an 80% combined ratio and has now seen that combined ratio actually go to up to over 100% as it has moved into new markets. So, as a result, we do have some concerns about this combined ratio increasing, and there are indications that the company's superior underwriting seems to be eroding over time. Now we really need to get some confidence behind this to make sure that this can be reversed. We will tell you that if we cannot get confidence behind this and we do not think that this combined ratio can revert back to lower historical range, then we would be most likely exiting our underweight position.

We also had two other names that underperformed this year, and again mostly flat in a very strong market, and those were Hittite and

Sirona Dental. So Hittite is a designer of analog performance integrated circuits that are used in digital, radio frequency, microwave, and cellular types of applications. Now these shares have been more in a holding pattern as their military market, which is about a one-third of their revenues, has been hurt by government funding cuts, and then on the cellular side has been hurt by a delay in upgrade projects in the U.S. and overseas. However, we continue to believe that the company has gotten a significant amount of new design wins, there is a significant amount of pent-up capital spending that will happen eventually, and the company has a pristine balance sheet with a lot of cash on it. We think that these factors will allow it to prosper and endure over the long term and we continue to be shareholders of Hittite.

Sirona Dental was another underperformer, although we owned the stock for less than two months in 2013. But a little background on Sirona: They are a manufacturer of dental technology and equipment, including CAD/CAM systems, imaging, and instruments. As I said, we recently bought the stock into the portfolio, but overall the stock has been rather sluggish as it experienced headwinds from a slow European economy, as well as a new product upgrade cycle for its CAD/CAM system that has been slowly ramping up and has temporarily diminished the overall growth rate for the company. Recall though that with Sirona, 2012 was actually a very successful year for the stock. The stock was up over 30% in 2012 and, with that slowing growth rate, the stock acted accordingly. Again, we continue to believe that their product differentiation and innovation should lead to more robust growth over time and, therefore, will benefit the shares.

As far as new names in the portfolio that we added in Q4, we have three: Sirona was one, which I just talked about; the other two were The Chef's Warehouse and Hibbett Sporting Goods. So, The Chef's Warehouse is a distributor of specialty food products in the U.S. that focuses on independent and fine dining establishments. Now, they are more focused on selling to more high-end, more independent, smaller types of restaurants. They aren't interested in the large chains. But, more importantly, they are focused on selling goods, such as specialty cheeses, truffles, caviar, and things like that. They have over 20,000 SKUs that have high-touch service. To give you an example, over 50% of a typical type of Chef's Warehouse distributor has an extremely high amount of culinary experience so these are people that go in and talk to the owner, operator, or chefs of restaurants and actually help them design menus given their high experience in culinary. Now, as a result, they can charge a much higher price than your typical types of food distributors, such as Sysco, and this really translates into the financials. So compared to Sysco, which we view as a much more commoditized type of distributor in food, the operating margins in Chef's Warehouse are 150 basis points higher than that of Sysco with much higher growth opportunities than at Sysco.

Hibbett—so Hibbett Sports operates sporting goods stores in more rural areas, mainly in the southeastern part of the United States. The focus here is more on team sports and apparel. So the benefit that Hibbett has versus other sporting goods stores or the larger mass markets, such as Walmart or even Target, is that because they are in more rural locations they can really operate much more frugally than those other stores. The larger stores, the Academies of the world, the Dick's Sporting Goods, those markets are so small for them that they don't even bother entering those stores. So Hibbett can go in, get a much more favorable lease, and really address that rural market very, very well. Again, this advantage allows them to get operating margins in the low teens versus other players in the industry, which have operating margins in the single digits.

I'm going to switch now to our portfolio characteristics. Again, I think if you look at overall characteristics, they continue to look very, very favorable versus the benchmark on various quality, growth, and value metrics. So I'm just going to call out a couple here that I think are very important. So, return on equity in our portfolio (dated as of December 31, 2013) the return on equity in our portfolio was 21.1% versus 8% for the Russell 2000 Index. This says that in a market of commodity businesses, we own proprietary businesses. The debt/EBITDA of 0.6x versus 4.4x shows us that our companies have a lot less debt on the balance sheet. Remember too that ROE that I just discussed, that can be enhanced by debt, so leverage actually makes that ROE higher. So our companies have higher ROE with less debt, so our companies have a much higher return on asset, return on capital profile versus the rest of the market. Earnings-per-share growth the last 10 years: 10.2% for us; 7% for the index. So again, outgrowing our markets over long periods of time. PE, trailing 12 months, 26x versus 33.6x for the Russell 2000. So again, we have over a 7 multiple discount to the market at this time. Free-cash-flow yield at 3.4% versus 0.7%. Again, our companies have less debt and generate greater free cash flow than the rest of the market. And lastly, the weighted-average market cap of $2.9 billion versus $1.6 billion. Now the $2.9 billion is probably one of the higher numbers we've registered in this portfolio, but I will tell you part of that has been the success of the markets, obviously the market is up over 30%. But our goal is that we continuously want to get that down, we want to get that closer to the weighted-average market cap of the Russell which is $1.6, as I said. We are consistently looking for new ideas that will drive this down over time. Remember this number is a trailing 12-month number, so it does take time for that to register and to bring that down. I just want everybody to know out there that our goal is to consistently bring that market cap weight down over time. And lastly, just to let you know, we have about 33 names in the portfolio as of right now.

So let's go to our market outlook. Obviously we've come through a very strong period of performance in small caps over the last five years as I talked about earlier. And clearly the stock market has priced in a very robust economic recovery over the next few years. Now we believe that the economy, though it continues to have some hurdles to overcome to improve the sluggish nature of this current recovery because it is one of the slowest recoveries we've ever experienced in our economy. Now, I don't think we're really calling here for a crash in the market, but we do believe there will be a reversion to the mean of some of the returns that would be appropriate. And the reason is—just looking at a couple of things that really drive the economy overall—I'm going to focus on consumer spending. Consumer spending is 71% of GDP. So unemployment, unemployment is a driver in consumer spending, right? Because people think if they have a job or they aren't going to lose their job, they'll continue to spend money. Well, we've got unemployment figures registering at new lows every single month, but if you look at the labor force participation rate, that's at a 35-year low. So I think there could be a lot of funny math going on with the unemployment figure. And that labor force participation rate, in my opinion, is a much more accurate view of where we are. I want to combine that with the fact that there are more college graduates now working at minimum wage than we have ever had in the history of our economy. So I think that unemployment still has a long way to go. I think the jobs we're creating are not those high-quality jobs that, in my opinion, literally drive consumer spending.

Housing—so housing prices have obviously had a nice recovery in 2013. Focused mainly on very affluent areas, as well as those areas that got really hit hard in the 2007-2008 era (Miami, Phoenix, the eastern part of California), they've all experienced a resurgence, although they are pretty much back to a little below where they were prior to 2007. However, we're seeing a range now where the interest rates are going to be. They've pretty much reached their nadir and are now projected to rise over time. So we believe that this could be a potential headwind to new purchasers of homes as well as consumers.

So when we kind of take all of this in aggregate, that's why we believe the market could adjust for factors given the robustness we have seen in the market.

So where do you want to be in this market? We continue to believe that small caps are the place to be over the long run. Given their track record of superior growth versus larger cap names, small-cap companies are still in their early stages of growing internationally and should benefit in the form of higher sales and margin enhancement. That is why we believe that small caps overall should continue to trade at a premium to the large-cap names. Also, over the long term, you want to own high-quality businesses that have sustainable competitive advantages, outgrowing their markets, low debt, and strong free cash flow that trade at discounted multiples to the greater market. That's where we invest, that's our history, and that's our future.

So with that, I'd like to thank you for your time, your interest, and continued trust and confidence.