KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 30

Fourth Quarter 2015 Review of the Small Cap Core Portfolio

Jon Christensen, CFA
Portfolio Manager & Senior Research Analyst

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

After last quarter's precipitous fall in the market with small caps being down 12 percent, the fourth quarter of 2015 was a somewhat different story with the Russell Index rebounding about 3.5 percent. This was in comparison to the 7 percent positive return for the S&P 500. So small caps trailed large caps overall in the quarter.

The sectors that drove the performance in the quarter were health care, utilities, and technology. On the downside, after being a huge laggard in Q3, energy was down again this quarter, falling almost 11 percent as a sector. Of course this was induced by the ongoing meltdown we have seen in oil prices.

So what types of businesses did drive the market? Companies that have low betas and little leverage on their balance sheets all outperformed their counterparts on 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 high-quality health care.

Let's look at some of the drivers of the outperformance in the quarter. Our Small Cap Core Portfolio outperformed the Russell 2000 Index by about 400 basis points in the fourth quarter. Given the bias to high quality, these results are what you should see from us given our quality philosophy.

Focusing more on the year 2015, it was definitely the year for large caps though overall the market was mundane at best. While the Russell 2000 Index fell over 4 percent in 2015—it's first negative year since 2011—the S&P 500 Index was up a scant 1.4 percent.

When looking at the sectors that held up better in a down market in 2015, they were health care, financials, and technology. Energy was down over 43 percent for the year, again driven by the decline in oil.

Focusing on small caps, there was a large bias toward high-quality stocks, including those with high S&P stock rankings and low betas. This difference is telling in that, in many of those metrics, the stocks were positive while their low-quality counterparts had negative returns.

Given the high-quality bias in the market combined with a benign and even lessening Fed presence, companies had 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 almost 7 percent in 2015.

We had a few names that drove some of the outperformance for the year: MarketAxess, Jack Henry, and RLI Corp. All of these stocks were up at least 30 percent for the year. We've talked about MarketAxess and Jack Henry in the past, so let me go into a little more detail on RLI. RLI is a specialty property and casualty insurance company offering coverage throughout the U.S. A focus on niche markets and the discipline to walk away from unprofitable business has resulted in a long-term track record of consistent underwriting profitability. Shares remain a strong performer as the company continues to report better-than-expected premium growth and earnings. RLI has also rewarded shareholders by returning excess capital in the form of special dividends, the last of which was paid in December of 2015.

Among the stocks that lagged in the year were ShutterStock, Artisan Partners, and Teledyne. Let me talk a little bit about Shutterstock. Shutterstock operates an online marketplace that allows customers to search and license commercial images from freelance contributors around the world. The shares have been under pressure since the end of 2014 after Adobe announced it was entering the stock-photo business via its acquisition of Fotolia. Shutterstock cut annual guidance in Q2 of 2015, which seemed to support these fears. However, management denied this was due to any impact from Adobe's launch. Q3 results were as expected, and our research continues to support our thesis that Shutterstock's competitive position has not been eroded by Adobe's entrance. While the share price is down significantly, we still expect Shutterstock to be an attractive investment over the long term given the strength and value proposition of its online marketplace.

We did not have any new buys or sells for the quarter.

Let's take a look at our market outlook. After seeing an essentially a "flat" market over the last two years in small caps, we have been experiencing a reversion to high quality as the market continues to have some hurdles to overcome to enhance the sluggish nature of this current "recovery." We believe the reversion to the mean to high quality is 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 has been adjusting for these factors and that stock picking is more important now than ever. So our contention is that over the long term, you want to own high-quality businesses that have sustainable competitive advantages, outgrow their markets, with low debt and strong free cash flow, that trade at a discount multiple to the greater market.

Our portfolio continues to look favorable versus the benchmark on those metrics. Return on equity in the portfolio of 24.2 percent for the last five years on average compares to that of 10.7 for that of the Russell 2000 Index; Debt to EBITDA of 1 times versus 5.7 for that of the Index; Earnings-per-share growth over last 10 years of 9.4 percent versus 6 percent for the Index; Price to earnings of 21.7 for the trailing twelve months versus 33.5 times for 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.