KayneCast

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Episode 7

Second Quarter 2014 Review of the Small Cap Quality Value Portfolio

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Hello, this is Julie Kutasov, co-Portfolio Manager of the Kayne Anderson Rudnick Small Cap Quality Value strategy. I would like to briefly offer some comments regarding the equity markets and our Q2 portfolio performance.

It was another interesting quarter for the equity markets. April saw an over 2.5% decline in the Russell 2000 Value Index which was followed by the index being up a modest 0.6% in May and a more robust 4.4% in June. In fact, all of the major small-cap equity indices saw similar high month-to-month return volatility.

The S&P 500 Index ended Q2 up 5.2%, achieving six consecutive quarters of positive returns—something that has not occurred since the late 1990s. Small-cap stocks lagged, but still realized a positive quarterly return such as that of 2.4% for the Russell 2000 Value Index. All of this, of course, follows a very robust 2013.

The low-quality headwind we faced last year persisted throughout the first half of 2014. Investor hunger for yield has not been any help either with our structural underweight in both real estate investment trust and utilities segments due to their inherent capital intensity, low competitive differentiation, and in the case of regulated utilities, also capped returns. Importantly, despite our underweight position in the REIT segment (which represents a sizeable over 13% of the Index) our financial-services sector holdings outperformed those of the benchmark in Q2, contributing 56 basis points to the portfolio's relative quarterly performance.

There were a couple of names, however, where company fundamentals drove the performance lower during the quarter. The greatest impact came from Interval Leisure Group, ticker IILG, which was added to the portfolio in Q4 last year and detracted 68 basis points from the quarter's performance, accounting for nearly two thirds of the Q2 relative underperformance.

Interval operates the nation's second largest timeshare exchange platform and also has a property management business that serves vacation condo owners and developers. Shares declined in early May after the company reported renewing several key customer contracts under inferior terms, and surprised investors with an announcement that it was entering property development via an acquisition of Hyatt's vacation ownership business. While the overall business continues to generate attractive margins and free cash flows, it is clear that industry dynamics have changed, reducing the company's pricing power and forcing it to expand its business model to a more capital-intensive vacation ownership platform. This change in Interval's business model meaningfully increases execution risk in our view. We held a detailed discussion with management and are currently reviewing our position in the company.

Last quarter we discussed with you two companies: First Cash Financial, ticker FCFS, an operator of pawn stores in the U.S. and Mexico, and CLARCOR, ticker CLC, a provider of after-market truck engine filters. Both had disappointing earnings announcements in Q1, leading to share price declines last quarter. In both cases we saw these issues as temporary in nature, remained confident in the companies' long-term positioning, and continued to own the stocks. In Q2, both FCFS and CLC recovered, being among top contributors to the strategy's performance for the quarter. And on July 17th, First Cash reported better-than-expected second quarter results and reaffirmed a solid outlook for the remainder of the year.

Running a focused portfolio of 25 to 35 names – there are currently 32 holdings in the portfolio – allows us to stay close to our companies and make investment decisions based on fundamentals of the underlying businesses rather than short-term issues or fears. That is why we focus on longer-term performance and encourage our clients to do so also. In fact, we like to think of ourselves as investors in businesses more so than investors in stocks.

While we are certainly disappointed with the underperformance of our portfolio relative to the Russell 2000 Value benchmark in Q2 and year-to-date, we are not letting short-term events or near-term volatility drive our decision-making and remain fully committed to our high-quality discipline and focused on the long-term outlook for our companies and our portfolio. Again, this comes after our portfolio's solid outperformance last year where we led the benchmark by over 800 basis points.

We understand that the investment philosophy of owning high-quality businesses may face headwinds during certain periods of time. And despite the portfolio's outperformance in 2013, we saw these headwinds for the better part of last year and so far this year. When investment-grade rated companies see lower returns than below investment-grade rated companies, when higher-beta companies outperform lower-beta companies, and when companies with low or no earnings do not underperform as we would typically expect, we know that this is not a favorable environment for us.

Nonetheless, this will not alter our belief that investing in high-quality businesses will yield superior risk-adjusted returns over the longer term. In fact, our discipline of being a high-quality investor has been proven through our long-term alpha generation.

Thank you again for taking time to listen to this recording today, and as always, if there are any questions or comments, please feel free to reach out to your representative contact.