



Kayne Anderson Rudnick

Thinking Beyond the Benchmark

Finding the high-quality sweet spot with the Kayne Anderson Rudnick Small Cap Core strategy

ACTIVE OR PASSIVE? So much of today's investment advice boils down to this simple, and perhaps overly simplistic, question. Should I pay for active management with the hopes of generating excess investment returns or instead "buy the benchmark" through a lower cost index fund? In the race for investment returns, index investing can make a compelling case as compared to many active equity strategies.

However, in the U.S. small cap equity asset class, the benchmark does not always provide the most compelling returns, as evidenced by the chart below, Small Cap Universe Comparison. This chart shows that many, if not most active managers in the U.S. small cap asset class, have outperformed the Russell 2000® benchmark over 3, 5, 10 and 20-year time frames. Stating that, how these managers have achieved their excess returns, and the corresponding risk taken, can vary widely. Investors should pay close attention to how returns by active managers have been achieved over multiple time periods, focusing on the consistency of excess returns over time.

When comparing returns of active managers to their benchmark, investors should review the underlying holdings in these portfolios.

In our view, the quality of the underlying businesses held in a portfolio is an important factor related to the consistency of investment performance and we believe that investing in quality businesses is an important contributor to capturing greater risk-adjusted returns, not just relative to the Russell 2000® Index, but to the overall equity market.

By focusing on companies with protected and differentiated business models, the KAR portfolio management team creates a portfolio of businesses that exhibit strong fundamental characteristics, such as a high return on equity and invested capital, low debt-to-capital, strong free cash flow, and consistent profitability. We believe these financial characteristics are strong indicators of a company's durability and competitive position within its industry.

Quality may seem like a secondary factor during periods when the U.S. equity markets are advancing in a consistent manner (as it did from 2009 to 2014). Quality companies will perform comparably during these periods. However, quality companies are typically standouts when equity markets correct. It is during these more difficult equity market periods, when investors are looking for safety, that quality counts.

PERCENT OF UNPROFITABLE COMPANIES:

KAR SCC

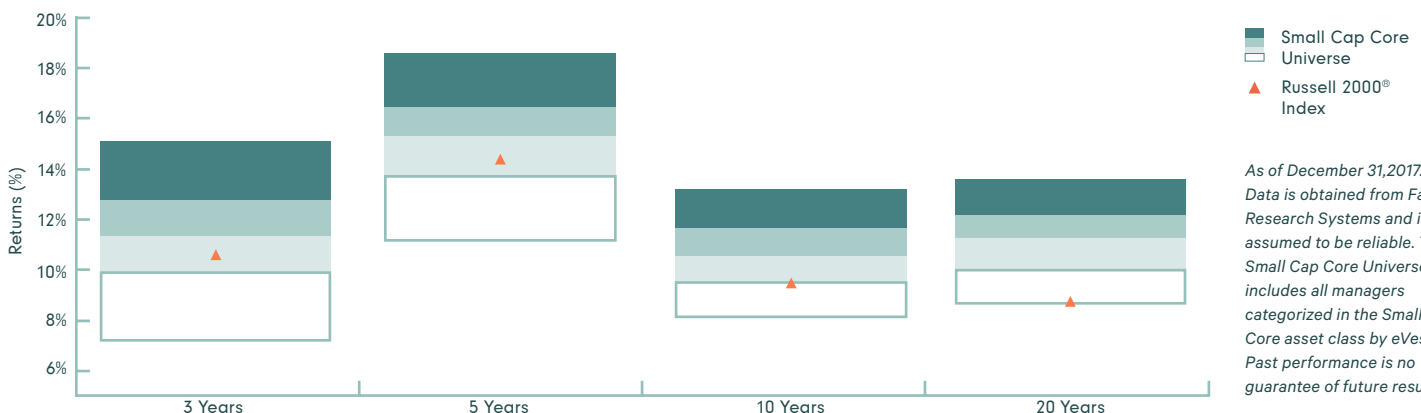
0%

RUSSELL 2000®

33%

Our mission is identifying the highest quality businesses in which to invest. Benchmarks, of course, are not built with the same discretion.

SMALL CAP UNIVERSE COMPARISON
Annualized Returns



Profiting From Well-Run, Profitable Companies

TO GET A SENSE OF WHY QUALITY COUNTS, take a look at one of our actively managed investments: the KAR Small Cap Core strategy. It invests in the small company universe benchmarked to the Russell 2000® Index.

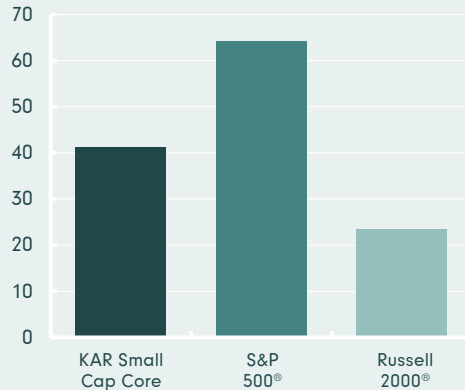
Our focus on quality gives our Small Cap Core strategy stronger fundamental characteristics and, subsequently, better risk and reward characteristics than both the benchmark small-cap universe and the larger market, as measured by the S&P 500® Index.

Data as of December 31, 2017. This material is deemed supplemental and complements the performance and disclosure at the end of this presentation. Data is obtained from FactSet Research Systems and BNY Mellon and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Past performance is no guarantee of future results.

WHAT'S IN YOUR INVESTMENT PORTFOLIO?

HIGH-QUALITY STOCKS

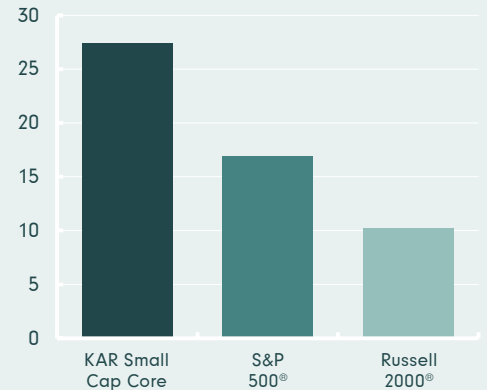
Percentage of holdings with S&P Quality Rankings of B+ or above



Getting the benefits of small company exposure, with the quality level of the larger market.

PROFITS

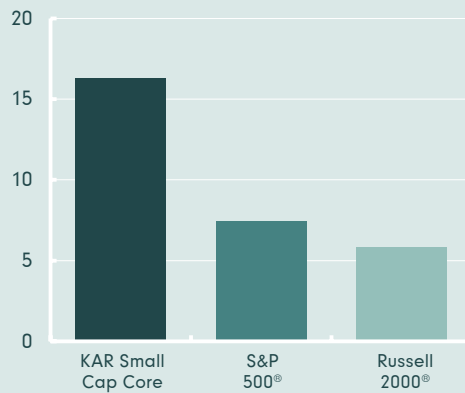
Five-year return on equity



Profitable companies produce better returns and are more likely to sustain in volatile markets.

DEBT COVERAGE

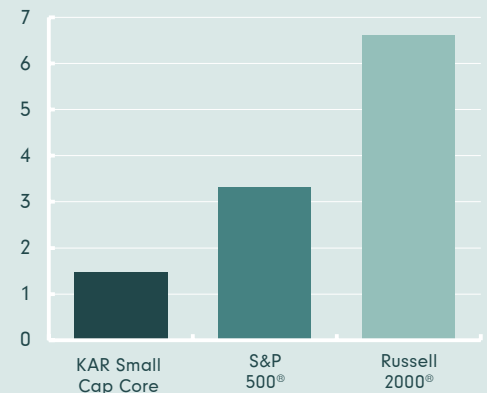
Interest coverage expense ratio



A higher interest coverage percentage means companies can more easily pay their debts in good times and bad.

DEBT

Total debt/EBITDA



Less debt translates to more free cash flow to fund future growth.

VALUE

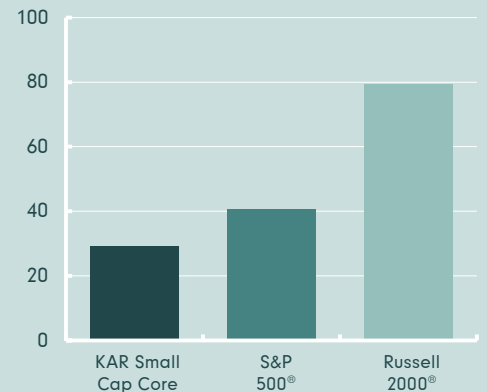
Trailing 12-month price-to-earnings ratio



Stocks with lower P/E ratios trade at a discount and have room to grow.

VOLATILITY OF EARNINGS

Earnings variance for the past 10 years



Lower earnings variance indicates companies have more predictable earnings over time.

Managing Risk to Keep Investors on Course

CAREFUL RISK MANAGEMENT is an important contributor to how the KAR Small Cap Core Portfolio has generated investment returns that have exceeded its benchmark. The small cap equity asset class is known for its potential to deliver excess returns over large cap stocks, but often with more risk. As quality investors of small cap equities, the risk profile of the KAR Small Cap Core Portfolio is closer to that of the S&P 500® Index of U.S. large cap companies than the Russell 2000® Index of U.S. small cap companies.

Investors often describe risk as the potential to lose money. The KAR Small Cap Core Portfolio, since its inception in 1992, has had more calendar years of positive returns and fewer calendar years of negative returns when compared to the Russell 2000® Index, as evidenced in the chart to the right. Further, during the two calendar-year periods that the KAR Small Cap Core Portfolio had a negative return, the strategy significantly outperformed the Russell 2000® Index in those periods. This translates to our clients losing money, in a single calendar year, once every 10 years versus once every 3 years for the Russell 2000® Index.

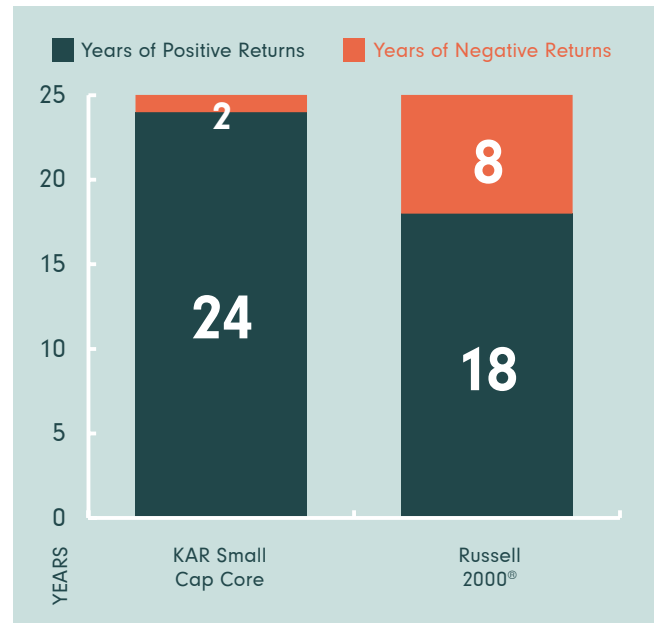
BETA	
KAR Small Cap Core	0.69
S&P 500®	0.61
Russell 2000®	1.00

Lower beta indicates less volatility than the market as a whole.

STANDARD DEVIATION	
KAR Small Cap Core	14.74
S&P 500®	14.02
Russell 2000®	18.45

Lower standard deviations indicate more consistent returns over time.

Data presented is inception of the KAR Small Cap Core strategy, April 1, 1992 through December 31, 2017. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

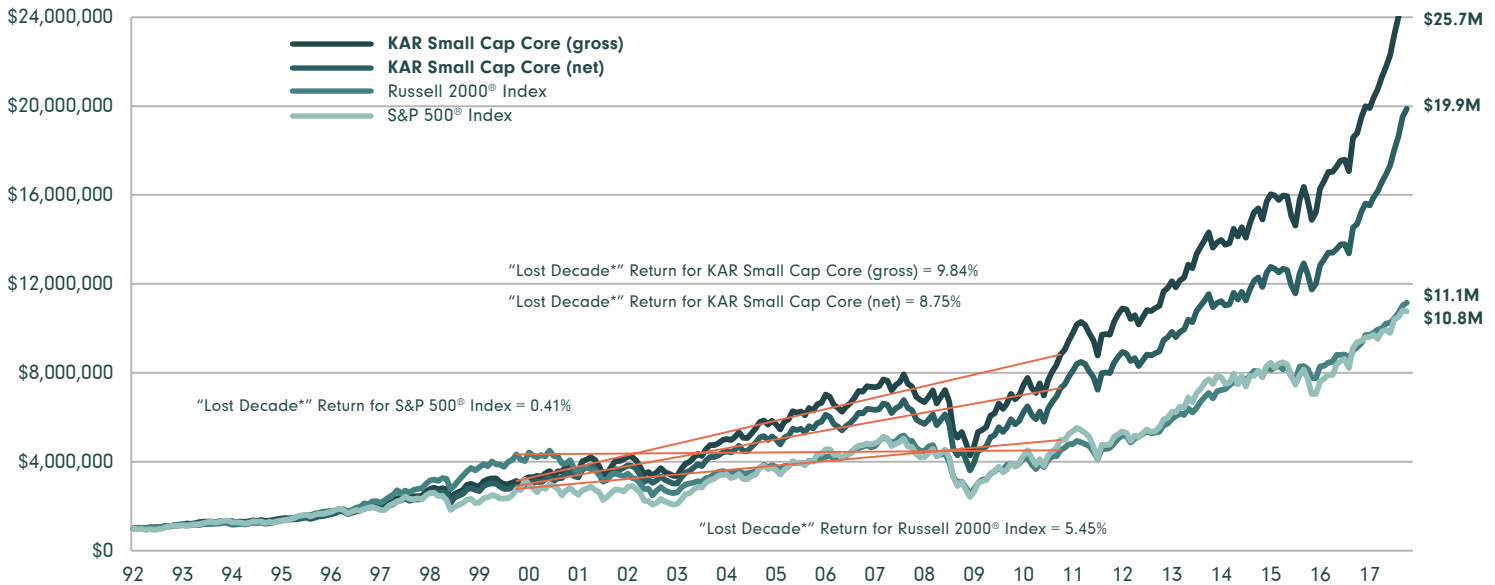


A concept in behavioral finance known as prospect theory tells us that investors feel the impact of negative returns more deeply than positive ones. At KAR, we strive to remain defensive even in the worst markets.

Unique Performer, Undeniable Performance

Instead of “active or passive?” investors would do well to ask themselves “high quality or low?”

IN THE END, all investors want an investment strategy that delivers returns. To get a sense of how the KAR Small Cap Core strategy achieves outperformance over the long term, consider how an investment of \$1 million in 1992 would look today. Through bull runs and despite bear markets, dollars invested in the KAR Small Cap Core strategy (gross of fees) grew more than double those within the Russell 2000® Index and S&P 500® Index.



*Lost Decade reflects time period between January 1, 2000 to December 31, 2010. Returns are annualized.

Chart reflects cumulative returns for KAR Small Cap Core since inception of April 1, 1992 through December 31, 2017.

This material is deemed supplemental and complements the performance and disclosure presented below. Past performance is no guarantee of future results.

DISCLOSURE Kayne Anderson Rudnick Investment Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Kayne Anderson Rudnick Investment Management, LLC has been independently verified for the period from January 1, 1999 through December 31, 2016.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The Small Cap Core Composite has been examined for the period from January 1, 1999 through December 31, 2016. The verification and performance examination reports are available upon request.

Kayne Anderson Rudnick Investment Management, LLC, a wholly owned subsidiary of Virtus Investment Partners, Inc., is a registered investment advisor under the Investment Advisers Act of 1940. Registration of an Investment Advisor does not imply any level of skill or training. Kayne Anderson Rudnick Investment Management, LLC manages a variety of equity and fixed-income strategies focusing exclusively on securities the firm defines as high quality.

The composite includes all discretionary institutional and pooled Small Cap Core Portfolios. Small Cap Core Portfolios are invested in equity securities with market capitalizations consistent with the Russell 2000® Index, that have market control, rising free cash flow, shareholder-oriented management, strong consistent profit growth and low-debt balance sheets. For comparison purposes, the composite is measured against the Russell 2000® Index. The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total-return basis with dividends reinvested. Benchmark returns are not covered by the report of the independent verifiers. The composite was created in April 1992. A list of composite descriptions and policies for valuing portfolios, calculating performance and preparing

compliant presentations are available upon request.

Prior to January 1, 2011, the composite minimum was \$250,000. Prior to December 31, 2010, only non-taxable portfolios are included in the composite. As of January 1, 2011, the composite was redefined to include both taxable and tax-exempt accounts. As of January 1, 2011, the composite was redefined to include both institutional and mutual fund [or pooled] accounts. Previously, only institutional accounts were included. Prior to January 1, 2011, accounts that experienced a significant cash flow, defined as aggregate flows that exceeded 25% of the account's beginning of period market value, were temporarily removed from the composite.

The standard management fee schedule currently in effect is as follows: 1.00% for the first \$25 million; 0.80% on the next \$25 million; 0.70% on the balance. Actual management fees charged may vary depending on applicable fee schedules and portfolio size, among other things. Additional information may be found in Part 2A of Form ADV, which is available on request. The performance information is supplied for reference. Past performance is no guarantee of future results. Results will vary among accounts. The U.S. dollar is the currency used to express performance. Returns are presented net of transaction fees and include the reinvestment of all income. Gross returns will be reduced by investment management fees and other expenses that may be incurred in the management of the account. Model net returns have been calculated by deducting 1/12th of the highest tier of the standard management fee schedule in effect for the respective period from the gross composite returns on a monthly basis.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns for accounts in the composite for the entire year. For those years when less than five accounts were included for the full year, no dispersion measure is presented. The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended at the following dates:

December 31	3-Yr Annualized Standard Deviation (%)	
	Composite	Benchmark
2011	20.61	25.34
2012	15.26	20.48
2013	11.81	16.68
2014	9.79	13.31
2015	11.28	14.16
2016	12.50	15.99

The Russell 2000® Index is a trademark/service mark of Frank Russell Company. Russell® is a trademark of Frank Russell Company.

Year	Total Firm Assets (\$ Millions)	Total Composite Assets (\$ Millions)	Accounts at Year End	Gross Annual Return (%)	Net Annual Return (%)	Russell 2000® Index Annual Return (%)	Internal Dispersion
2007	5,392	138	41	3.16	2.14	(1.57)	0.48
2008	3,445	69	31	(27.64)	(28.40)	(33.79)	0.54
2009	4,010	75	23	32.09	30.80	27.17	0.55
2010	4,729	63	22	25.00	23.79	26.85	0.76
2011	5,232	362	88	10.14	9.08	(4.18)	0.67
2012	6,545	541	102	13.42	12.29	16.35	0.33
2013	7,841	1,018	121	30.10	28.84	38.82	1.41
2014	7,989	965	145	7.51	6.43	4.89	0.24
2015	8,095	1,048	157	2.37	1.36	(4.41)	0.23
2016	9,989	1,303	209	19.10	17.93	21.31	0.49

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