Episode 47

Fourth Quarter 2016 Review of the Small Cap Quality Value Portfolio

Julie Kutasov
Portfolio Manager & Senior Research Analyst

Hello, this is Julie Kutasov, Portfolio Manager for Kayne Anderson Rudnick's Small Cap Quality Value strategy. Today, I am here to provide a fourth quarter 2016 review, and highlight some of [the] portfolio holding changes and stocks that have contributed positively as well as negatively to the overall performance.

Despite a challenging start to 2016, equities enjoyed a year of very solid returns, with the S&P 500 Index up nearly 12 percent, and small cap stocks posting even more impressive gains, with the Russell 2000 Index advancing 21.3 percent. After a weak first half of the year, stocks began an impressive surge in the third quarter that continued through the fourth quarter led by the surprise outcome of the November Presidential election.

Stock market returns were particularly robust in the fourth quarter, with investor post-election enthusiasm, oil markets' recovery, and accommodative monetary policy worldwide helping propel markets to all-time highs. The Russell 2000 Value Index, this strategy's benchmark, increased 14.07 percent in the fourth quarter, bringing the full year 2016 return to an impressive 31.74 percent.

Investors embraced the notion of an ideological change in Washington that is expected to deliver meaningful stimulus through tax reform, infrastructure spending and deregulation, driving up valuations of higher-beta, pro-cyclical segments. To give you some color, the benchmark's higher-beta names (those with beta over 2, representing over 10 percent of the Index) were up a robust 18 percent during the quarter and 41 percent for the year. The fourth quarter's Russell 2000 Value benchmark's performance was primarily driven by energy, financial services and materials sectors while health-care, utilities and consumer-discretionary sectors lagged.

An expectation of a faster pace of short-term interest rate increases (coupled with the potential for reduced regulatory burden) drove up valuations of some segments (such as banks and life insurance companies) while "bond proxy"-like segments (such as utilities and real estate) continued to lag. Banks represent over 20 percent of the Russell 2000 Value Index, and were up a robust 29 percent during the quarter and 43 percent for the year.

Clearly, this is not a favorable environment for us as high quality investors, and our Small Cap Quality Value Portfolio lagged the Russell 2000 Value Index during the quarter. The roughly 230 basis points underperformance was driven primarily by negative stock selection in the technology and energy sectors where our portfolio holdings are particularly different from those of the benchmark. We did benefit, however, from our strong stock selection in the producer-durables sector as well as an underweight exposure to the underperforming utilities sector. Recall that for us, this underweight exposure to utilities is structural in nature, due to the segment's inherent capital intensity, low competitive differentiation and highly regulated (capped) returns profile.

The two positions that contributed most positively to performance during the quarter were Primerica and RE/MAX Holdings.

Primerica is a life insurance company that underwrites and distributes term life insurance and sells third-party investment products via independent representatives to middle-income households in the U.S. and Canada. Importantly, the company has the largest life insurance distribution force in the country—something that would be very hard for any competitor to replicate. Shares were strong, particularly following the Presidential election, driven by investor expectations of rising short-term interest rates and potential deregulation, as it relates to the recently finalized Department of Labor's Fiduciary Rule that is scheduled to go into effect in April this year. With the shares up strongly, trading at an attractive valuation, we reduced our overweight position in the company during the quarter.

RE/MAX is a global franchiser of residential and commercial real estate brokerage offices. Due to properly aligned incentives, where the agent gets to keep approximately 95 percent of all commissions, RE/MAX attracts the best talent, with the company's agents being on average twice more productive versus competition. Shares performed strongly, driven by the company's solid agent growth and attractive purchases of several independent RE/MAX agencies.

The two stocks that detracted the most from the quarter's performance were Syntel and Monotype Imaging—both technology companies.

Syntel is an IT outsourcing company serving a broad range of industries including financial services (American Express is one of the company's largest clients), health care, and retail. Shares lagged during 2016, driven by the company's reports of weaker-than-expected operating results, which the company blamed on sluggish end-market demand. Although some of these challenges are likely to be temporary in nature, we became concerned that Syntel's competitive positioning was, in fact, deteriorating, with the company being unable to match highly innovative Cloud offerings coming to market. We were also disappointed by the company taking on a significant amount of debt recently in order to pay a sizable (15 dollar per share) one-time cash dividend. Adding to our concerns was an elevated level of turnover within the company's senior management team over the past couple of years. With these considerations in mind, we exited our position in the stock during the quarter.

While we are certainly disappointed with the stock's recent underperformance, it is important to note that the company was added to the Portfolio more than ten years ago—in May 2006. Including several position increases and trims, and the 15 dollar special cash dividend paid on October 3rd 2016, the stock's cumulative return for our ten-year holding period was nearly 119 percent versus 33 percent for the Russell 2000 Value benchmark for the same time period. And the company's contribution to the Portfolio's performance over the past five years was also [a] solid 92 basis points.

Monotype Imaging engages in development, marketing and licensing of technologies and fonts. Even if you've never heard of Monotype, its products are very familiar to you. The company controls, through non-expiring trademarks, some of the world's most popular fonts, including Helvetica, Times New Roman and Arial. As a result, Monotype's fonts are the industry standard on laser printers, and are used to represent roughly half of the Fortune 500 companies. High quality and consistency of these fonts are even more vital today, when any communication (including marketing) takes place via a broad spectrum of digital devices, from desktop to smart-phones and tablets to automotive displays.

Shares lagged, however, driven by investor concerns over Monotype's recent acquisition of Olapic, a company helping corporate marketing departments leverage user-generated content on social media. Investors are worried that the acquisition could require significant additional investment, and reduce the company's solid profitability over the longer term. We believe that Olapic's addition to the platform is value enhancing. Olapic has an enviable blue chip client list (including the likes of Lancôme and JetBlue) which Monotype's core business could immediately benefit from, through cross-selling and product-bundling. Importantly, Monotype's balance sheet and free-cash-flow generating ability remain solid, with the company returning excess cash to shareholders in the form of regular cash dividends and opportunistic share repurchases.

We initiated two purchase programs during the quarter. Both were still in progress at quarter-end, so we'll discuss these with you next time. As I mentioned earlier, we sold our position in Syntel. We also sold our position in Village Super Market. Let me provide some more detail on Village Super Market.

Village Super Market owns and operates a chain of ShopRite supermarkets in New Jersey, Maryland and Pennsylvania. The company was founded by the Sumas family back in 1937, and the family continues to run the business and remains a large shareholder. Cognizant of the highly competitive nature of the supermarket business, we were initially attracted to the company's differentiated business model. Village is a member of Wakefern, the largest supermarket co-operative in the country, which allows it to benefit from the co-op's buying power as well as back-office and IT support. Over the past several years, however, Village has been challenged by the intensifying competitiveness of the industry, resulting in gross margin pressure and the need to make meaningful capital investments to maintain consumer traffic. Additionally, the company has recently announced plans to enter the highly competitive New York City market with a Bronx store. Although the company continues to boast a strong cash-rich balance sheet, these concerns led us to the decision to exit our small position in the stock during the quarter.

While we are certainly disappointed with the relative underperformance of our portfolio in the quarter, 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 longer term outlook for our companies and our Portfolio.

We are also very satisfied with the Portfolio's positioning, both in absolute terms and versus the benchmark on all of the quality, growth and value metrics that we monitor and manage to. Five-year average return on equity for our companies stands at an impressive 20.2 percent versus just 7.9 percent for the Index. Importantly, it is derived from solid under-leveraged balance sheets, with Debt-to-EBITDA ratio for our companies of 1.7 times versus 6.3 times for the Index. Diluted earnings per share compounded annual growth for the past 10 years (which includes the Great Recession) for us stands at a solid 8.1 percent versus 4.3 percent for the Index. Our companies have grown quarterly cash dividends per share at an impressive compounded annual growth rate of 9.7 percent over the 10 years versus just 1.6 percent for the benchmark. Importantly, the Portfolio's valuation at the end of the quarter stood at a meaningful over six multiple discount to the Index, with the trailing twelve months price-to-earnings ratio of 25.3 times.

We understand that the investment philosophy of owning high-quality businesses may face headwinds during certain periods of time. When credit spreads tighten, when higher-beta companies outperform lower-beta companies, we know that this is an unfavorable environment for us. Nonetheless, we remain confident 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 do not hesitate to reach out to us.