KayneCast

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First Quarter 2017 Review of the Small Cap Core Portfolio

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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 first quarter of 2017, discuss the drivers of performance, talk about new names and sells in the portfolio, and conclude with a market outlook.

The first quarter of 2017 was generally positive for equities with the S&P 500 returning over 6 percent in the quarter. Smaller stocks didn't fare as well, but the Russell 2000 Index still increased about 2.5 percent in Q1. This was a deceleration from the almost 9 percent return in Q4 2016. After stocks accelerated after the November election in hopes of a Trump administration agenda that would be implemented sooner rather than later, clearly we have seen that sentiment cool off as health-care repeal and replace seems elusive and corporate tax reform could be delayed as well. Which proves once again that in the end, what matters is picking high-quality businesses that can sustain growth in good and bad times. The ongoing ability to predict market swings and trends continues to elude many. When dissecting the quarter by month for the Russell 2000 Index, January was up a scant 0.4 percent, February was slightly better at a 1.9 percent return. Lastly, March was basically flat.

The sectors that drove the performance in the quarter were health care, technology and basic materials. On the downside: Energy, consumer staples and financials all lagged. So what types of businesses did drive the market? The small cap market was skewed more towards lower quality in the quarter. Companies with low S&P stock rankings, stocks with low credit ratings, high P/Es and high betas all outperformed their counterparts on those metrics. Our Small Cap Core portfolio outperformed the Russell 2000 Index by 345 basis points in the first quarter. Despite the lower quality bias in the market, stock selection was more pronounced in determining the performance. Superior stock selection in financials, producer durables and consumer discretionary were enough to overcome the low quality tailwind.

We had a few names that drove some of our outperformance for the quarter: Autohome, Primerica and MarketAxess. Let me talk a little bit about Primerica. Primerica underwrites and distributes term life insurance and sells third-party mutual funds, via independent reps to middle income households in the United States and Canada. The company has the largest life insurance distribution force in the country. Shares had been under pressure for the first half of 2016 due to concern regarding how the Department of Labor's Fiduciary Standard Rule would impact the retirement investment account industry. While the final language of the Rule was less onerous than feared, some questions had remained over the ultimate cost of implementation. The new Trump administration has delayed implementation of the rule and there is a good chance that it may never be enacted. With this overhang now removed from the stock, investors have focused on the fundamentals of the business, which generated EPS growth of 18 percent in the most recent quarter. Given our favorable expectations about the long-term earnings power of the company, we remain shareholders.

The names that lagged for the year were Shutterstock, Abaxis and Dril-Quip. We will discuss Shutterstock a little later, so let me go more into Dril-Quip. Dril-Quip designs, manufactures, sells and services engineered offshore drilling and production equipment, including subsea and surface wellheads, and production trees, subsea control systems and manifolds. Shares lagged driven by continued weakness in deepwater drilling activity due to depressed crude oil prices. Our view of the company's long-term market positioning remains intact. We continue to believe that Dril-Quip is better protected both as a "best of breed" mission-critical equipment supplier and a low cost manufacturer. Importantly, Dril-Quip has a long-term track record of disciplined capital allocation (with a focus on organic growth and returning excess cash to shareholders in the form of opportunistic share repurchases), and the company's balance sheet remains pristine with plenty of cash and no debt.

We had one new purchase and two sells in the quarter. Our new purchase was Fox Factory Holdings. Fox Factory designs and manufactures premium suspension products for use on mountain bikes, all-terrain vehicles, off-road trucks, snowmobiles and motorcycles. Fox has developed —over many years—a favorable reputation for high performance suspension products among mountain bike and off-road vehicle enthusiasts. Fox maintains over 50 percent market share in the front fork and rear shock suspension products on premium mountain bikes (over 3,000 dollars). The company has a high return on capital and a very conservative balance sheet. The opportunities going forward are to leverage the Fox brand and expand into related vehicle markets and adjacent product categories such as on-road vehicles with off-road capabilities. Capital allocation has been rational with M&A focused on adjacent markets.

We had two outright sales in the quarter: Shutterstock and Exponent.

Let's talk about Shutterstock first. The share price had rebounded in the first half of 2016 as concerns regarding the competitive threat from Adobe's new stock photo offering abated. However, a meaningful slowdown in revenue growth the past two quarters has sent the share price lower. Our original investment thesis was based on the network effects of Shutterstock's core stock photo marketplace business. Even at lower growth rates, that marketplace business is very profitable and valuable. Unfortunately, the profits from that great business will remain depressed as management seeks growth by investing capital to grow other parts of the company where Shutterstock's competitive advantage is less clear. For these reasons, we have sold our position.

The other sale we had was Exponent. Our investment in Exponent has been a fruitful once since our initial investment in 2009. Exponent has returned on average over 24 percent annually versus the Russell 2000 Index's 14 percent performance in the same time period. The business continues to perform well, fundamentally, despite top-line sales growth muted by some large contracts rolling off and exposure to the energy markets creating some headwinds. Even with these headwinds, they are turning that into EPS growth in the high single digits. However, we just don't feel the current valuation creates room for multiple expansion, while at the same time we don't see sales acceleration in the medium term. Despite our confidence in the business, we would rather sell our position now at these levels—thus allowing us to move funds into other ideas with more attractive risk-rewards metrics—rather than maintain a very small position. We will continue to monitor the business for future opportunities to revisit the investment story.

Let's go into our market outlook now. After seeing a rebound after the November election, the market has continued to have an upward trajectory, but clearly the companies that many believed would benefit from a Trump agenda have not yet come to fruition. While we have had recent quarters of high- and low-quality tailwinds trading places, we continue to believe that stock picking matters in all environments, but especially those with more benign long-term GDP growth expectations, which is where we are today. 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 discount multiples to the greater market.

Our portfolio continues to look very favorable versus the benchmark on many of these metrics. The return on equity in this portfolio as of the end of March: 27 percent versus 10 percent for the Russell 2000 benchmark; debt to EBITDA for our portfolio of 1.3x versus 5.4 for the Index; EPS growth in this portfolio the last 10 years: 13 percent versus 6.5 for the Russell 2000. Lastly, the trailing 12-month P/E of 24.5 for us versus 39.1 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.