KayneCast

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

The second quarter of 2017 was again positive for equities with the S&P 500 returning over 3 percent in the quarter. Smaller stocks performed in line with their larger brethren, with the Russell 2000 Index increasing 2.5 percent (about the same performance as last quarter). With health care and tax reforms outlooks oscillating between bright and dim, the market seems to be digesting these issues on a daily basis, which is creating uncertainty and a market with no great direction. 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, April was up 1 percent, May was down 2 percent. Lastly, June improved by 3.5 percent.

The sectors that drove the performance in the quarter were health care, utilities and technology. On the downside: Energy, consumer staples and basic materials all lagged. So what types of businesses did drive the market? The small cap market was very mixed this quarter in terms of high and low quality. On the one hand, companies with high credit ratings, low betas and less debt on their balance sheets outperformed their counterparts on those metrics. However, companies with lower S&P stock rankings and high P/Es also outperformed. Our Small Cap Core portfolio outperformed the Russell 2000 Index by 460 bps in the second quarter. Superior stock selection in technology, consumer discretionary and financials drove the outperformance.

We had a few names that drove some of our outperformance in the quarter: Autohome, Fox Factory and HFF. HFF is a broker in the United States commercial real estate market. Its professionals place debt, raise equity capital, and provide transaction advice to buyers and sellers of commercial real estate. The company has built a well-regarded reputation and its culture and compensation structure attract high-performing transaction professionals. HFF has continued to take share as evidenced by its 18 percent growth in revenues in the most recent quarter despite a decline in overall industry volumes. We don't have a particular near-term view about the real estate cycle but believe HFF would survive any downturn, and will continue to gain market share, and that industry transaction volumes over time are likely to grow. As a result, we remain owners of the business.

The companies that lagged the most in the quarter were Primerica, Dril-Quip and Core Labs. Let me discuss some details on Core Labs. Core Laboratories is one of the world's leading providers of proprietary and patented reservoir description, production enhancement and reservoir management services to the oil and gas industry. Shares lagged due to the challenging operating conditions driven by depressed crude oil prices. Our view of the company's long-term market positioning remains intact, however. We continue to believe that Core Labs—with its comprehensive portfolio of value added products—is well positioned to assist major oil companies in enhancing project economics through improved recovery. Core Labs is recognized as the industry's innovation leader with a number of revolutionary products introduced over the past several months. The company remains a strong free-cash-flow generator, returning excess cash to shareholders in the form of cash dividends and share repurchases.

Let's talk a little bit about new names and sells in the portfolio for this quarter. We had one new purchase and one sell in the quarter. Our new purchase was Manhattan Associates. Manhattan Associates is a vertical software provider, focused on complex supply chain and omni-channel solutions. The company helps customers reduce inventory, optimize warehouse operations and drive other supply chain efficiencies. Manhattan's customers are in retail, wholesale, manufacturing, medical and other segments—with inventory being a major use of capital. Manhattan's has also expanded to help retailers to point of sale manage their omni-channel strategies, and drive incremental sales. Manhattan's clients rely on the software to run their complex supply chain operations. Once the mission-critical software is in place, it becomes the backbone of a client's inventory passage through its supply chain. Manhattan is the authority on supply chain software. In competing with upstart technology providers, it has a product breadth and reputation that smaller companies cannot match. Large companies are unlikely to trust their supply chain to a less established rival, even at a lower price. Manhattan carries no inventory and has very modest capital expenditure requirements. As a result, the company has generated free cash flow in excess of net income since 1999.

We had one outright sale in the quarter, and that was Chefs' Warehouse. We sold our position in Chef's Warehouse given the much lower-than-normal weight in the portfolio combined with our desire to increase the name in other portfolios so we can avoid exceeding our ownership limit we have in place.

Let's talk about the market outlook now. Q2 of 2017 was very similar in many aspects to Q1. Another quarter of 2.5 percent returns with mixed messages on drivers of the market in terms of high and low quality. 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 favorable versus the benchmark on these metrics. The return on equity in this portfolio of 28.7 percent matches against the benchmark's of 10 percent; debt-to EBITDA for us is 1.5 times versus 6 times for the Russell 2000 Index; earnings per share growth the last 10 years: 13 percent versus 6.2 for the Index. With a price to earnings trailing 12-month ratio of 26.8 for us versus 38.5 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 very much for your time, interest and continued trust and confidence.