Episode 59

Fourth Quarter 2017 Review of the Small Cap Quality Value Portfolio

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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 and full year 2017 review and discuss our outlook for 2018.

Global equities performed spectacularly in 2017, with the S&P 500 Index returning 21.8 percent for the year, marking 2017 as the first calendar year ever with no monthly losses in the Index.

Solid stock market returns in the fourth quarter were driven by better-than-expected earnings (with growth rates accelerating in the U.S., Europe, Japan and many emerging countries), favorable economic data (benign inflation and low interest rates), and continued progress and final passing of tax reform.

Both for the quarter and the year, growth stocks outpaced value names (the opposite of what occurred in 2016), and larger stocks outperformed smaller cap names. The Russell 2000 Value Index, this strategy's benchmark, increased 2.05 percent in the fourth quarter, bringing the full year return to 7.84 percent.

Despite the Federal Reserve's raising short-term interest rates three times in 2017, the 10-year U.S. Treasury yield remained relatively steady, ending the year at 2.4 percent. One byproduct of lower rates has been underperformance of interest rate-sensitive segments, such as banking and real estate. Both segments are sizeable in the Russell 2000 Value Index, with banks representing a roughly 18 percent weight and Real Estate Investment Trusts (or REITs) a nearly 12 percent weight.

While lower quality stocks (as described by lower S&P Quality ranking) outperformed both during the quarter and the year (not a favorable environment for us), benchmark names with higher returns on equity outperformed by a wide margin. With nearly 70 percent of our portfolio in names with returns on equity over 15 percent (versus less than 6 percent of the Russell 2000 Value Index), the strategy outperformed the Index by 272 basis points over the fourth quarter and 1240 basis points over the year.

Sector-wise our strong relative performance in the fourth quarter was driven primarily by strong stock selection in the consumer discretionary, financial services and technology sectors. The full year outperformance was driven by strong stock selection in the consumer staples, financial services, producer durables and materials sectors. Both during the quarter and the year, we also benefited from our structural underweight exposure to the underperforming banking and REIT segments.

Importantly, both for the quarter and the year, we exhibited strong stock selection within our high-quality universe with portfolio names rated as "B+" and above by S&P Quality Rankings, outperforming those higher quality names in the benchmark by a wide margin.

The two positions that contributed most positively to performance during the quarter were SiteOne Landscape Supply (ticker

SITE) and Thor Industries (ticker THO).

Added to the portfolio in the first quarter of 2017, SiteOne is also our highest contributor for both the year and the trailing five-year period. The company is the largest and only national wholesale distributor of landscape supplies. Its customers are landscape contractors who service both residential and commercial accounts. The company's size allows it to exert pricing pressure on suppliers, while at the same time commanding premium pricing versus local competition. SiteOne continues to consolidate the highly fragmented wholesale landscape supply industry; this increased scale, coupled with a number of successful supply chain initiatives, has driven gross margin expansion. Importantly, despite being the largest player, the company holds just a 10 percent market share leaving plentiful room for top-line growth and further profitability expansion.

Thor is the largest manufacturer of recreational vehicles (or RVs) in the U.S. The company is also our fourth highest contributor for both the year and the five-year period. Scale is no less vital in this industry as it allows Thor to enjoy significant purchasing power with suppliers, which translates into meaningful advantages in cost of materials over smaller competitors. Shares performed strongly in the fourth quarter following the company's reports of robust, better-than-anticipated revenue and earnings growth. Thor, along with other RV manufacturers, continues to benefit from younger buyers entering the RV market primarily with purchases of entry-level towable units. These first-time buyers also represent an opportunity for future sales as they get older and seek more comfort, potentially upgrading their vehicles.

The two stocks that detracted the most from the quarter's performance were National Beverage (ticker FIZZ) and RE/MAX Holdings (ticker RMAX).

Some of you may recall our discussion of National Beverage as a strong contributor in prior quarters. The company remains our second highest performer for the year (following SiteOne) and the third highest for the five-year period. As a reminder, National Beverage manufactures and markets flavored beverages, including soft drinks, juices, teas and sparkling waters. It is the company's sparkling water LaCroix brand that has been driving National Beverage's robust growth in the environment where consumers have been shifting away from carbonated soft drinks to healthier beverages. Despite the company's impressive operating results, shares declined during the quarter due to investor profit-taking following an extended period of the stock's solid performance. We continue to believe that LaCroix has plentiful growth opportunities, while the company's recent launch of Shasta flavored sparkling water may serve as another meaningful growth driver. Importantly, the company remains a solid free-cash-flow generator, boasting a pristine balance sheet and returning excess cash to shareholders in the form of sizable special dividends.

RE/MAX is a global franchisor of residential and commercial real estate brokerage offices. Due to properly aligned incentives, where an agent gets to keep approximately 95 percent of commissions, RE/MAX agents are twice more productive than competition. In addition, the company has established a reputable brand that attracts both agents and customers. Shares declined in early November following an announcement of an internal investigation with a group of independent directors looking into an undisclosed loan from the company's founder to the co-CEO, as well as other potential employment practice violations. Despite the investigation, the company confirmed that business fundamentals remained solid and expected this to continue going forward. While disappointed with this apparent internal controls' failure at RE/MAX, we remain confident in the company's business model and its ability to generate superior returns over the longer-term.

There were no new purchases during the quarter, but we did complete the sale of Monotype Imaging Holdings (ticker TYPE).

As a reminder, Monotype controls some of the world's most popular fonts, including Helvetica, Times New Roman and Arial. Shares struggled following the company's 2016 acquisition of Olapic—a company helping corporate marketing departments leverage user-generated content on social media. Investors were worried that the acquisition would require significant additional investment and reduce Monotype's solid profitability over the longer-term. Our research at the time led us to the conclusion that Olapic's addition to the platform was value-enhancing. Olapic had an enviable blue chip client list, which we believed 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 remained solid, with the company returning excess cash to shareholders in the form of regular cash dividends and opportunistic share repurchases. We grew disappointed, however, with the management's execution post-acquisition, which we partially attributed to challenges presented by the fast-changing nature of Olapic's industry. We continue to believe that Monotype's core font assets' positioning remains intact. With our conviction in the viability of the company's new operating model reduced, however, and with the shares' valuation improved, we made the decision to exit our position in the company.

In summary, we are very satisfied with the Portfolio's current positioning, both in absolute terms and versus the Russell 2000 Value benchmark on all of the quality, growth, and value metrics. Five-year average return on equity for our companies stands at an impressive 23 percent—over three times higher than that for the Russell 2000 Value Index. Importantly, it is derived from solid, underleveraged balance sheets with Debt-to-EBITDA ratio for our companies of less than two times—nearly five times lower than that for the Index. Diluted earnings per share compounded annual growth for the past ten years (which includes the Great Recession) for us stands at a solid 11 percent—nearly twice that of the Index, and our companies have grown quarterly cash dividends per share at a compounded annual growth rate of nearly 12 percent over the past ten years—nearly four times faster than the benchmark.

Our market outlook for 2018 is favorable overall, albeit 2017 will certainly be a hard act to follow. We do expect volatility to increase in 2018 as markets return to more normal conditions. We expect the corporate tax cut to be beneficial to both businesses and shareholders, with increasing free cash flow potentially applied to capital spending, share repurchases, increased dividends, and acquisitions. While more commoditized, less differentiated segments (such as apparel, energy and banking) are likely to pass these savings back to their customers in pursuit of market share gains, higher quality businesses (those with proprietary protections and unique innovative products) should be able to retain the benefits, some of which have already been priced into the equity market, but not all.

We do not foresee any significant impediments to growth over the next year or two and believe that 2018 should continue to provide investors with mid-to-high single-digit equity returns, albeit most likely not without a bumpy ride along the way.

As always, we remain fully committed to our high-quality discipline and focused on the long-term outlook for our companies and our portfolio. We also 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