Episode 39

Second Quarter 2016 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 2016, discuss the drivers of performance, talk about any new names in the portfolio, and conclude with a market outlook.

The second quarter of 2016 was a much more smooth ride than we had in Q1, which got us off to a very volatile start to 2016. In April, the Russell 2000 Index grew 1.6 percent and then accelerated slightly in May to increase 2.2 percent while June brought home the quarter being flat, after rising early and then getting pummeled over a two day period by the Brexit vote. Interestingly enough, the market made almost the entire Brexit downfall in the next three trading days. In the end, the Russell 2000 Index was up 3.8 percent in Q2. This was in comparison to the 2.5 percent positive return for the S&P 500. So, small caps were the place to be in the quarter.

The sectors that drove the performance in the quarter were utilities, materials, and energy. On the downside: consumer discretionary, producer durables, and technology lagged.

So what types of businesses did drive the market? Companies with high S&P stock rankings and low betas outperformed their counterparts on those metrics. The quarter had a slight high-quality bias, but not overwhelming. Materials and energy being in the top provided some indications given the more low-quality nature of those sectors.

Our Small Cap Core Portfolio outperformed the Russell 2000 Index in the second quarter. Given the slight bias to high quality, these results are what you should see from us given our high-quality philosophy.

We had a few names that drove some of our outperformance for the quarter: Primerica, Shutterstock, and MarketAxess. We've talked about MarketAxess in the past, so let me go into a little more detail on Shutterstock and Primerica.

Shutterstock operates an online marketplace that allows customers to search and license commercial images from freelance contributors all over the world. The shares have been under pressure since the end of 2014 after Adobe announced it was entering the stock-photo business via its acquisition of Fotolia. A cut to annual guidance in Q2 of 2015 seemed to support investor fears regarding Adobe; however, management denied there was any impact on their business from Adobe's launch. Results over the following quarters, including Q1 2016, have shown no erosion in Shutterstock's competitive position or business results since. As Shutterstock continues to report strong quarterly results, investor's concerns regarding Adobe are abating and the share price is increasing. Most recently, the company announced a partnership with Google to provide images across a range of Google's ad products. This has provided positive momentum for the stock into Q3.

Primerica underwrites and distributes term life insurance and sells third-party mutual funds via independent representatives 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 past year due to concerns about how the Department of Labor's fiduciary standard proposal would impact the retirement investment account industry. The final language of the proposal was less onerous than feared, so the impact on Primerica's investment products should be limited. This positive outcome coupled with strong quarterly results in Primerica's insurance business drove the share price higher.

Stocks that lagged in the quarter were Autohome, Computer Programs and Systems, and Chef's Warehouse. We've talked about Autohome in the recent past, so we can give you some color on Computer Programs and Systems as well as Chef's Warehouse.

Computer Programs and Systems, a provider of health-care information technology for rural and community hospitals, has seen its shares be impacted by the lower spend by their customers as the meaningful use mandate begins to subside and competition becomes more pronounced. CPSI provides systems for small and rural hospitals and can provide a higher level of customization and service that larger players cannot.

The Chefs' Warehouse distributes specialty food products in the United States and Canada, focusing on serving the specific needs of chefs who own and operate independent restaurants, fine dining establishments, country clubs, hotels, caterers, and specialty food stores. Q1 results were lower than expected, which caused management to reduce its full-year profit guidance. Business performance remains a bit erratic as the company continues to digest the significant operational investments and expansion into protein it has made over the past couple of years. While we are frustrated by the uneven results, we view these investments to be prudent for the long-term health of the business and expect margins and cash flow to continue to improve this year, so we remain owners of the business.

As far as new names or sells in the portfolio for the quarter, we had none. No new purchases and no outright sells for the quarter.

Let's move on to our market outlook. After seeing essentially a volatile start to the year, the market has seen a steady pace upward as we have been experiencing a reversion to high quality as the economy continues to have some hurdles to overcome to enhance the sluggish nature of this current "recovery." We believe the reversion to the mean to high quality is appropriate as interest rates eventually head back up, and the current geo-political environment creates volatility and an unsettling future for global growth rates.

Putting this all together, we believe the market has been adjusting for these factors and that stock picking is more important now than ever. 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 benchmarks on these types of metrics. For example, return on equity for our portfolio is currently 25 percent versus 10 percent for the Russell 2000 Index, debt to EBITDA of 1.2 times versus 6.4 times that of the Index, earnings-per-share growth over the last 10 years for our portfolio over 11 percent versus 5.9 percent for the Index, and a P/E on a trailing twelve month basis of 22.2 versus 32.6 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.