KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 15

Fourth Quarter 2014 Review of the Small Cap Quality Value Portfolio

Craig Stone
Portfolio Manager & Senior Research Analyst

Hello, this is Craig Stone, co-Portfolio Manager of the Kayne Anderson Rudnick Small Cap Quality Value Portfolio. Today, I will be briefly discussing some highlights for our portfolio in Q4, as well as for the full year 2014.

2014 was certainly an interesting year with a tale of two halves for our high-quality-focused investment style. The first half of 2014 saw a continuation of the bias towards quality investments, as investors continued their willingness to reward low-quality stocks with higher prices and multiples. This low-quality trend has been in place pretty much since the middle of 2012. However, beginning in Q3 2014, this all changed.

Starting in the third quarter, high-quality investments started to outperform low-quality investments, and this carried forward into Q4 as well. Our Small Cap Quality Value Portfolio nicely outperformed the Russell 2000 Value Index in Q4. Part of the reason for the outperformance was due to our focus on quality investments, but also in part due to the significant decline of the energy sector, and our under-representation in that area. I will discuss more about the energy sector momentarily.

Despite the portfolio's relative outperformance to the benchmark in the second half of 2014, we still ended the full year slightly trailing the benchmark's return due to the underperformance over the first half of the year. We were close in making up that first half deficit with our second half performance, but the year ended before we could fully catch up. If this was a football game, it would have recorded as a loss on our record for 2014.

Luckily, this is not a four-quarter event and we get to continue to prove our ability into 2015 and beyond. Our long-term record of outperformance and alpha generation is the ultimate proof of our ability to deliver not only above-benchmark return, but doing so taking on much less risk than the benchmark of our peer group.

If you listened to our podcast in previous quarters in 2014, you will recall our remarks about certain attributes such as high beta and higher indebted company stocks having done better than lower-beta, lower indebted—or cash rich— company stock counterparts.

With the reversal into quality investments for the 2nd half of 2014, much of the full year 2014 attribution now has been altered, and it's tilted toward quality investments. We are very much encouraged by this change in investors' sentiments and believe that the quality cycle is now being favored.

However, there is one attribute that has been fairly constant throughout the year. I am speaking of investors' continued appetite for higher-yielding stocks.

For all of 2014, stocks in the Russell 2000 Value Index with dividend yield greater than 3% had total returns exceeding nearly 13%. This group of stocks comprised over 20% weight in the entire benchmark. Conversely, stocks in the benchmark that did not pay a dividend had a negative half-percent return, and this group accounted for nearly 36% weight in the benchmark. The disparity between these two segments is staggering and notably one of the widest in recent history.

The disparity was also evident in the industry/sector returns for the year in the Russell 2000 Value Index. The higher-yielding stocks of Real

Estate Investment Trust, or widely known as REITs, along with utility segments, were the best performing stocks in the benchmark.

In 2014, REITs in the Russell 2000 Value Index had returns of 23% while utility stocks were up 19%. This is in sharp contrast to the overall benchmark return of 4.2%. Investors' penchant for anything of high yield regardless of stock valuation has led these two groups' stock to trade at historic high valuations.

Clients who know us have seen over time that our portfolios have historically seen much lower levels of investments in REITs and utility stocks. Combined, these two segments represent nearly 20% of total benchmark weighting.

Our preference for differentiated business models, high returns on capital, and lower capital intensity businesses has led to our lower appetite for REITs and utility stocks in general. Though in the past we have owned a few REITs, we currently do not own any REITs in the portfolio and currently only own one utility stock.

Going forward, if REITs and utility stocks continued their straight upward march we may be challenged to overcome that bias. However, over a longer period of time, we have demonstrated the ability to overcome this bias with superior stock selection. Also, fundamentally, we do not believe that lower return on capital businesses can outperform higher return on capital businesses over the long term.

While overcoming REITs and utility stocks has been challenging, we have also benefitted, particularly in Q4, from the recent collapse of the stocks in the energy sector. As most of you have seen and heard, the oil commodity price has plunged from over $100 a barrel to the current sub $50 price. While filling up the car's gas tank has been far more wallet friendly, investors in energy stocks have not been enjoying it as much.

We have not had many periods where our portfolio had an overweight in energy stocks. Again, typically, we prefer less capital-intensive businesses and certainly many companies in the energy space defy that model. As a result, we owned one energy service company prior to the oil price collapse and have since sold that company early in Q4.

So currently, we have no holdings in energy, and this sector accounts for roughly 3.5% in the Russell 2000 Value Index.

We have always said that whenever an industry or sector is under pressure, we like to look and see if we can find a company that is under similar industry price pressure but not operating under the same industry fundamental pressure. So the hunt has begun for us in the energy sector to find a suitable candidate.

We are not shying away from the sector. Nor are we trying to predict what oil prices will be in a month, a quarter, or a year from now. We believe that if we can find the right protective, differentiated business that can demonstrated the ability to generate high returns on capital over a full economic cycle, and that has a strong balance sheet, we are willing to invest in that company no matter what economic sector in which it participates.

This is what we have always believed and is one of the main reasons for our long-term success.

With that I'd like to thank you all for listening today. As always, we welcome any comments or questions that you might have. Have a good day.