KayneCast

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Episode 19

First Quarter 2015 Review of the Small Cap Core Portfolio

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Hello, I'm 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 in 2015, discuss the drivers of performance, talk about the new names and sales in the portfolio, and conclude with a market outlook.

After a solid fourth quarter—with small caps being up over 9%—the first quarter of 2015 was somewhat more muted, but the Russell 2000 Index was still up over 4%. This was in comparison to the just less than 1% return for the S&P 500.

The sectors that drove the performance in the quarter were health care, materials, and technology. On the downside, energy continued its downward trajectory, albeit not falling by the cataclysmic 35% [it experienced] last quarter. In Q1, the energy sector fell about 2%.

So what types of businesses did drive the market? Companies that have lower S&P stock rankings, and higher leverage on their balance sheets outperformed their counterparts on each of those metrics. However, companies with low betas also outperformed. So we did not have the clear low-quality tailwind that we had seen in parts of 2014 and most of 2013.

We believe it merits calling out health care in particular as an outlier since it was a large driver of the Index's performance. For some perspective, biotechs are now an 8% weight in the Russell 2000 Index, up from 4% in 2012. In Q1 of this year, health care was up over 12% versus 4% for the Index. Of particular note, eight of the top ten contributors to the Russell 2000 Index in Q1 were biotech firms. Of those eight, seven were not profitable, and as you know, we do not invest in businesses that do not make money.

Our Small Cap [Core] portfolio performed in-line with the Russell 2000 Index. Given the issues discussed previously, we believe the in-line performance on this short-term basis is understandable. The highest contributors of the quarter were MarketAxess, Factset, and Jack Henry. All of these stocks were up at least 12% in the quarter. We've talked about MarketAxess in the past. So let me go into a little more detail on Jack Henry.

Jack Henry is a provider of transaction-processing services for banks and other financial institutions, mostly smaller or mid-size entities. Once in place, Jack Henry's core-processing system becomes highly integrated with a client's core operations, thus making switching to a new vendor costly, time-consuming, and disruptive. This model has created wonderful financials, with 20% return on equity from a very low-debt balance sheet and consistently higher margins over time.
Among the stocks that lagged in the quarter were Core Labs. Core Labs is a name that's relatively new to the portfolio, added in Q4 2014. They are a provider of proprietary reservoir description and production-enhancement services for the oil and gas industry. With the dramatic drop in oil prices, many higher-quality energy names have been hit hard as a result, and Core Labs was no exception. However, we believe that Core Labs has differentiated product offerings that are valuable to E&P companies on both the exploration and production side of the industry.

We sold one name in the quarter, that being Thor Industries, a manufacturer of recreational vehicles in the U.S. We sold our position—

which was an underweight relative to our other businesses—based on valuation as well as more compelling investment opportunities in other businesses.

Let's go to our market outlook. After several years of observing a low-quality tailwind in equities, we have been experiencing a reversion to higher quality as the economy continues to have some hurdles to overcome to improve the sluggish nature of this current "recovery". We believe a reversion to the mean in returns is under way and appropriate as interest rates seep 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 is in the process of adjusting for these factors. So our contention is that over the long term, you want to own high-quality businesses that have a sustainable competitive advantage, outgrow their markets, and have 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. For example, the return on equity in this portfolio is almost 23% versus 10% for the Index, Debt to EBITDA of 0.9x for us versus 5.5x for the Index, earnings-per-share growth the last 10 years of 12% plus versus 6% for the Index, with a trailing P/E of our portfolio of 27.3x versus 35x 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.