Episode 20

First Quarter 2015 Review of the Small Cap Quality Value Portfolio

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Hi, I'm Craig Stone, Portfolio Manager of the Small Cap Quality Value Portfolio. The first quarter was a good quarter for equities, particularly small and mid-cap stocks which outperformed their large-cap counterparts. Growth stocks did better than value stocks. Corporate earnings and revenue continue to grow and companies are maintaining historically high operating margins. However, the strength in the U.S. dollar is hurting the reported earnings of many large-cap multinational companies, whereas smaller companies—which we are buying—are benefitting from having much less foreign earnings exposure.

Also, unlike what we saw last year, there was no distinct edge for either low-quality companies over high-quality companies as [was] evident in the first half of 2014, or vice versa, what we saw in the second half of 2014, where high-quality companies definitively had the upper hand. In this first quarter of 2015, it was a mixed result. In the Russell 2000 Value Index, the S&P high-quality-ranked stocks underperformed lower-quality-ranked stocks. Similarly, companies with investment-grade-rated bond ratings underperformed junk-bond-rated companies.

However, for the first time in over a year, lower-dividend-yielding stocks in the benchmark actually outperformed higher-yielding stocks. This meant that stock selection mattered rather than just buying industry and sector stocks with high dividend yield regardless of valuation.

Here at Kayne, we thrive on periods where stock selection and active management can contribute to returns, and accordingly we saw our Small Cap Quality Value portfolio outperform the benchmark in the quarter. Our performance for the trailing-12-months period is outstanding as well given the severe headwinds facing high-quality companies have now dissipated.

Strong stock selection in the technology and consumer-discretionary sectors helped propel our portfolio's outperformance in the quarter. In looking at the individual stocks, the top contributors for the trailing 12-months were Cinemark Holdings and RLI Corp. Cinemark, the third largest domestic movie exhibitor and leading movie exhibitor in Latin America continued to drive healthy attendance and concession growth despite a multitude of challenging factors like anemic box office for 2014, and more recently, currency headwinds, but Cinemark has reported better growth than its larger domestic counterparts, and the international market continues to be very under-penetrated. Additionally, a potential stronger film slate in 2015, and film releases more evenly spread throughout the year should also be a tailwind for the company.

In RLI, a specialty insurer, we own a company that has had an enviable track record of premium growth which continued over the past year. The management of RLI focuses on niche markets and is disciplined, willing to walk away from unprofitable businesses, resulting in a long-term track record of consistent underwriting profitability. Capital allocation has also been an excellent historical mark of the management team, particularly returning excess cash to shareholders. Last December, the company paid a special dividend of $3 per share and has had a history of such payments.

If we look at our lowest contributing stock over the past 12 months, that name is CARBO Ceramics which we sold in Q4 last year.

Shares of CARBO lagged along with other energy-sector peers driven by a dramatic drop in crude oil prices. We believe that this will have curtailed future domestic drilling activity, and already, we have seen a sharp decline in the U.S. rig count. Subsequently, we sold our position in CARBO more due to the deteriorating fundamental positioning of CARBO's products, which is seeing increased price competition, than [due to] to the pure decline in oil prices.

If you looked at our historical energy holding in the portfolio, we have never had a large weighting in this sector. This is not because the energy sector typically represents less than 5% of the Russell 2000 Value Index, but more because fundamentally, energy companies are mostly capital intensive, highly leveraged, and commodity price takers, but over the years, we have always had success in finding energy companies that have developed some proprietary technology or product offering that can offer [more] competitive protection than a pure commodity-driven exploration and production company [can].

After selling CARBO, we were fine with having no representation to the energy sector, as we have done previously in the utility sector and currently in the real estate investment trust (or REIT) industry. However, as oil prices continued to tumble during the first quarter down to the $40 a barrel level, we decided that we wanted to purchase Core Laboratories—an energy-service company—in the portfolio.

We have known about Core Laboratories for a long time. This company has one of the highest margin and return on invested capital in the entire energy sector. Because of its tenured success, the stock has always traded at a very high premium relative to the market and relative to the overall energy sector, but as we saw investors fearfully abandon financial companies without regard during the global financial crisis, we saw the same happening with the energy stocks in Q1.

But let's get something straight here; we are not trying to predict oil prices. We do not know where oil prices are heading next month, next year, or even the next five years. We are stock-pickers. We buy fundamentally high-quality companies, and what we do know and we have seen from Core Labs' history is that the company's business model has allowed the company to generate—even at the depth of past oil troughs—very high return on invested capital, and this is a high ROIC not just relative to other energy companies but relative to all other sectors as well.

As I conclude here, I am not going to spend much time with market outlook commentary. If you are interested, Doug Foreman, our Chief Investment Officer, offers his insight in his podcast that I would highly recommend, but here are a few of my thoughts. Investors are consumed with trying to guess the timing of the Federal Reserve's likely hike of Fed Funds. Whether it is June, September, or even later is inconsequential to the management of our portfolios. Our companies have not benefitted much from the sustained lower rates of the past five years, as they are typically cash rich or employ very little leverage. And with the initial rate hike expected to be minor, it is also unlikely that our companies will see any significant benefit.

So, at the end of the day, what we do know is that in a modest growth economy and maturing economic cycle, we very much believe high-quality businesses with protected markets are a better place to invest than lower-quality companies operating in a more competitive environment. We are seeing the initial move towards high quality and believe that it will be sustained.

With that I want to thank you for listening to this quarter's recording, and as always, if you have any questions or comments please do not hesitate to contact us.