KayneCast

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Episode 31

Fourth Quarter 2015 Review of the Small Cap Quality Value Portfolio

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Hello, this is Craig Stone, Portfolio Manager at Kayne Anderson Rudnick. Today I will be making some brief comments on the fourth quarter equity market along with some highlights of our Small Cap Quality Value Portfolio.

In 2015, large-capitalization stocks, as measured by the S&P 500 Index, did see a 1.38 percent gain while the Russell 2000 Value Index dropped 7.47 percent. But during the fourth quarter, equities rallied across the board in both large and small asset classes. The Russell 2000 Value Index was up 2.88 percent in the fourth quarter.

Whether it is because of the sharp declining oil prices, the economic slowdown in China, or the Federal Reserve's first rate hike in almost a decade, all of these factors played a part in 2015's equity volatility. Though in Q4 we saw positive returns for the equity market, it was nevertheless a tough environment for small-cap equities overall for the full year of 2015. And so far in 2016, it has not been good for the equity markets as well, with investors' sentiment very negative for equities across the board.

As for our portfolio's performance, we strongly outperformed during the fourth quarter and for full year 2015. Our high-quality businesses, as we have seen historically, were able to generate outstanding relative performance. As we have always stated with our investment strategy: owning high-quality businesses typically offers better capital protection during challenging times in the market. And once again we saw that during 2015. Our portfolios' downside protection during this challenging market environment was exemplary. Our capital protection has continued thus far into 2016 as well during this period of market volatility.

The biggest driver for the market currently is still the energy market and the impact it has had on the credit market overall. High-yield spreads have widened, but most dramatically for energy-related bonds. This in turn has made riskier assets less desirable and thus the outperformance of high-quality stocks that typically have much lower debt levels or no debt at all.

There are three main drivers for quality cycles: credit cycle, interest-rate cycle, and profit cycle. We are seeing if not all three factors, but certainly at least two of these factors currently tilted in favor of quality stocks. And even if the Federal Reserve Board puts the rate hikes back on pause in the near term, it is no longer the headwind to quality stocks that we have experienced since the economic recovery post the financial crisis in 2008.

Now, looking in detail at the fourth quarter, energy continues to be the weakest sector followed by the consumer-discretionary sector in the Russell 2000 Value benchmark. What did well during the quarter were technology and health-care sector stocks.

It is no surprise that with the widening credit spread, companies with lower debt-to-capital levels outperformed companies with higher debt-to-capital levels. And in the quarter, higher beta stocks also underperformed lower beta stocks. And we can say in general, higher dividend yielding companies did better than its lower yielding counterparts as well.

Specifically, for our portfolio, from a sector standpoint, we had good stock selection in the financial services while stock selection in the producer-durable sector detracted from our performance.

The two companies that contributed most to performance during the quarter were National Beverage and Heartland Payment Systems.

Interestingly, these were the same two companies that were also the highest contributors for the portfolio in the third quarter as well. National Beverage develops, manufactures, and markets flavored beverages for sale across the country. Its beverage portfolio includes soft drinks, energy drinks, juices, teas, sparkling waters, and enhanced beverages. While FIZZ, the ticker symbol for National Beverage, has seen its carbonated soft-drink brands report weak sales trends like [the] rest of the industry, these declines have been more than offset by growth in its La Croix sparkling-water brand. As a result, overall revenue and earnings are up strongly driven by record growth in La Croix. These strong results, which we expect to continue, coupled with a cash-rich balance sheet are behind the reasons for the stock's strong performance and behind the reason for our continued ownership of this business.

Heartland Payment Systems provides bankcard processing services to small and mid-size merchants in the United States. Heartland recently received an acquisition offer from Global Payments, ticker GPN, for an effective 29 percent premium price. The deal consists of both cash and exchange of shares into GPN stock. Once the deal concludes, the combined market capitalization of the company will be over $10 billion, which is extremely high for our small-cap portfolio. We will be seeking an alternative high-quality business with lower capitalization to invest the proceeds.

On the other hand, the companies that contributed the least to performance during the quarter were Corporate Executive Board and Cheesecake Factory. First, CEB was also one of the two lowest contributors to the portfolio in the third quarter as well. The company provides best business practices research and talent-management tools to business executives and professionals worldwide. With 100 percent of the Fortune 100 as customers, CEB benefits from a substantial network effect. The stock saw weakness in the quarter due to concerns that the recent staffing issues will have a lasting impact on top-line growth. Management has taken steps to remedy the situation. Despite this interruption, we remain confident that the value of CEB's products will be realized, resulting in strong product and customer growth down the road.

The second lowest contributor stock is Cheesecake Factory, an upscale casual restaurant chain. Cheesecake Factory, like that of other dining establishments (both quick-service and casual-dining operators) are facing some challenges in the form of wage pressure, particularly in states where higher minimum-wage regulations have been enacted. We believe the underlying fundamentals of the company's operations are sound, but acknowledge that there could be short-term earnings swings in 2016. The fact remains that the company is consistently outperforming the rest of the industry, with less volatility over the long term. In addition, there are pricing actions that the company can choose to enact, like regional pricing, to offset some of the wage pressures.

Many of our clients have asked about our take on the recent market declines and our thought about the recent economic events as a whole. I don't think I could do justice in my podcast here as there are multi-factors that need to be addressed and discussed. Our Chief Investment Officer, Doug Foreman, has recently recorded such a podcast and addresses all of these issues and concerns. I would strongly recommend that you listen if this is of interest to you.

In closing, we are encouraged after multi-years of investors favoring low-quality stocks that we saw the turn in 2015 and the outperformance of high-quality stocks. We believe that this could just be the beginning of sustained performance for high-quality businesses. And as history has dictated, high quality typically outperforms low quality over a long period. This bodes well for our high-quality businesses long term.

However, we also believe that investors should expect more modest equity returns going forward than what we have seen over the past years. Global economic growth is still struggling and without key participation from emerging markets, it would be hard for developed markets to garner above historical GDP growth. Specifically, Japan and Europe continue to see anemic growth. The U.S. may be best positioned globally and small-cap stocks have the best exposure to the domestic economy. Having pricing power will be important and our high-quality business models should prove to be advantageous in this type of environment.

As always, thank you for listening to this recording and we welcome any questions or comments you may have.