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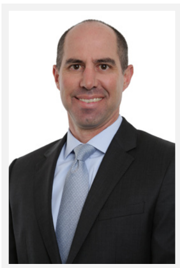
A Podcast Series by Kayne Anderson Rudnick



Episode 5

First Quarter 2014 Review of the Small Cap Core Portfolio

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This is Todd Beiley, co-portfolio manager of Kayne Anderson Rudnick's Small Cap Core strategy. Today I'm going to review recent performance of the portfolio, discuss market conditions, and provide our investment outlook.

Our portfolio has trailed the market's recent rapid rise over the past several months. Specifically, the portfolio has gained a little over 15% over the past year, compared to a gain of over 24% for the Russell 2000. I'll briefly discuss two holdings that lagged during the year, but I'll also talk about market conditions that we think overwhelmingly have contributed to our lag in relative performance.

Abaxis sells diagnostic instruments used at the point of care. The company offers a highly disruptive device that allows doctors to obtain basic blood chemistry analysis in a much shorter period of time, right at the point of care as opposed to sending samples out to a central lab. The company has established meaningful market share in the veterinarian industry and created significant competitive barriers by becoming integrated within the vet's practice.

Since becoming shareholders in 2007, the stock has provided us a return that has modestly exceeded the benchmark. Over the past year, the company has encountered volatile purchasing patterns by its new large distribution partners, which has hurt the current rate of business growth. We think end-customer demand will remain very healthy over time, and we don't believe these issues detract from the company's fundamental strengths. We continue to own the stock.

Haemonetics is a leading provider of apheresis equipment. This is equipment used to automatically extract certain elements from the blood – plasma, platelets, etc. – while a patient is donating. The stock has been relatively weak over the past year as investors have been disappointed with the company's efforts to develop new areas for growth, particularly in blood management solutions for hospitals.

We purchased shares of the company in 2007, on the belief that their high market share – which exceeds 60% in certain cases - in each of their primary collection markets reflected high competitive barriers. Over time, we have been disappointed with the company's ability to retain pricing power and generate attractive profitability in its core markets. Therefore, we began selling our position near the beginning of the year. In total, since our initial purchase, our investment in the company resulted in a return that modestly exceeded the benchmark.

The more significant cause of our recent underperformance is related to market conditions that have dramatically favored riskier assets. Amid highly stimulative monetary policy, risk premiums have collapsed. In other words, investors are willing to incur more risk for the same or less prospective return. This is a natural result of human behavior within an environment of highly accommodative monetary policy where the cost of capital is kept near zero.

We see evidence of this upward re-pricing of riskier assets in narrowing credit spreads, which are now near their lows of the last two decades, as well as more speculative equities rising rapidly in price. Those companies with little or no current earnings but the potential for large future earnings have done the best. These would include biotech, emerging technology, and renewable energy companies.

Consider this; the 10 companies that contributed most to the rise in the Russell 2000 over the past year have negative earnings in aggregate, yet their combined market value approaches $50 billion. For sure there is meaningful innovation and change occurring in these areas, but as history has taught us, only a small minority of companies within new fields will ultimately prove successful.

Looking ahead, we have very high conviction that our portfolio is positioned to provide very attractive returns, not only on an absolute basis, but particularly on a relative one. The trailing 5-year return of the Russell 2000, at close to 25% per year, is the highest it has been in 30 years. This pace is of course unsustainable, and we expect small-cap equity returns to normalize toward their long-term average over the coming years. Under this scenario, we would expect our portfolio to perform very well given the exceptional economic nature of the businesses we own, particularly when compared to those of the broader small-cap market. Specifically, when looking at the fundamental characteristics of our portfolio today, the businesses earn over 20% on their equity capital, which compares very favorably to less than 9% for the benchmark.

In addition, their balance sheets are much healthier. Less than 1x debt/EBITDA versus 4.5x for the portfolio. Our businesses have very durable competitive barriers, which allow them to gain market share over time, enabling their earnings growth to be sustainably higher. Ten-year EPS growth of companies in our portfolio exceeds 10% - much better than the 6.5% of the Russell 2000. In addition, we own these businesses at much better prices. The P/E discount of our portfolio today is over 11 points. That's the widest it has been in many years.

So, when you put together the economic fundamentals of the businesses that we own, as well as the prices at which we own them, they stack up much more favorably against the benchmark, and these are the traits that will dictate return and risk over time. On this basis, our portfolio is very well positioned. Historically we have provided exceptional relative results when risk premiums normalize, which we would expect to occur over the coming years.