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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Seeking International Small Caps with a Sustainable Competitive Advantage

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SECTOR — GENERAL INVESTING

TWST: What is the overall philosophy of the international small-cap portfolio?

Mr. Thrasher: The philosophy of the strategy is similar to the overall philosophy of Kayne Anderson Rudnick. We have built our business around buying high-quality, small-cap companies at a reasonable price. Our flagship small-cap core strategy dates back to 1992, so we have been running that strategy for 20-plus years. Since inception, we have outperformed the benchmark by about 3% annualized with much less risk than the benchmark, which in that case is the Russell 2000. Over those 20-plus years, the strategy has been down two years versus the Russell 2000 benchmark, which has been down seven years over that same time period.

One of the things that we like about the small-cap space is the relative inefficiency of the asset class. In 2010, we decided to look at the possibility of applying the same approach to the international small-cap marketplace, and what we found was that international small cap is even more inefficient than the domestic small-cap market. So we thought it was an area where we have the opportunity to buy the same kinds of great companies that we have always invested in on the domestic side, but we're finding them at much more attractive valuations than comparable companies listed domestically. So we seeded the strategy in late 2011, and we launched the mutual fund in September 2012.

TWST: You mentioned the term high quality. For you, what does that mean?

Mr. Thrasher: Quantitatively, what we are looking for are companies that can earn high returns on invested capital over a market cycle, and we are looking for companies that have the ability to do that with an underleveraged balance sheet and preferably unlevered balance sheet. That's the quantitative side of it, but that is probably less important than the qualitative side of it.

We spend most of our time trying to figure out, qualitatively, what is it about this business that is going to allow them to continue to achieve those high returns on invested capital for many years into the future? Economics 101 will tell you, if you are earning high rates of return on capital, then it's going to attract competition. What we are looking for in our research is, what is it about this company that will allow them to fend off that increased competition, and continue to maintain high returns on capital and strong profitability in spite of that increased competition? It could be strong brands, network effect, low-cost advantage or something else, but some form of sustainable competitive advantage is the most important thing that we are looking for when I say high quality.

Of course, we are looking for those quantitative metrics, but it's really the qualitative that is much more important because that ultimately will lead to the sustainability of those quantitative metrics. A lot of times, companies look strong quantitatively, but without competitive barriers, over a three-, five-, 10-year period, they will ultimately run into trouble. You see that in areas like retail or consumer electronics, for example, where a company comes up with a product, and it's a great product, and they can earn a high return on capital for a time, but then, they have a lot of copycats, and if they don't have something that is a strong competitive advantage over the long term, those high returns will get eroded.

TWST: What is the initial step of finding an idea in such a large universe?

Mr. Thrasher: One of the things we are trying to do is find great, high-quality companies that haven't been recognized by the institutional investor or sellside community. The international small-cap universe is very large, so one of our primary tools is screening. We also travel and visit a lot of companies and ask about their competition. We will take ideas anywhere we can find them. We are always looking, and we are trying to turn over as many rocks as we can.

markets as well. Korea is our largest weight in emerging markets, which is, for all intents and purposes, a developed country but still classified by MSCI as emerging. We feel comfortable investing in Korea because of the political and economic stability.

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One of the tools we have is leveraging our experience investing in high-quality domestic small-cap businesses. We have been looking at small-cap businesses for over 20 years, and through that experience, we have learned many lessons about what types of business models are successful and sustainable over time. Many of our holdings have business models that are very similar to companies that we have owned or followed in our domestic strategies for many years.

TWST: Right now, the strategy has quite a bit of exposure to Australia. Why is that?

Mr. Thrasher: Like everything that we do, our geographic exposure is driven by the bottom up. If you looked at our portfolio when we started the strategy, our largest weighting was in Japan. From a macro perspective, there was nothing to like about Japan three and a half years ago, but because of that, we were able to find several very high-quality companies trading at attractive valuations. And the same thing is true about Australia now.

There is nothing that we structurally love about Australia per se. We just happened to have found businesses there that we really love, and we have found them at valuations that we really like. Now, it's probably not coincidental that the Australian market has underperformed recently. They are seen as heavily tied to commodities and China, so there are some areas of the market there that are significantly under pressure due to that. That can present the opportunity for us to buy companies at attractive valuations where we otherwise might not be able to find them. We don't necessarily love a poor economic outlook, but sometimes that's what allows us the valuation opportunity.

TWST: Are there any places you won't invest in?

Mr. Thrasher: Yes, we do need to have a certain amount of political and economic stability in order for us to invest. The majority of our investments are in developed markets, but we do invest in emerging markets as well. Korea is our largest weight in emerging markets, which is, for all intents and purposes, a developed country but still classified by MSCI as emerging. We feel comfortable investing in Korea because of the political and economic stability.

Likewise, our largest position in emerging markets is in Taiwan where, again, you have a relatively stable political and economic environment. In some of the less developed emerging and frontier markets, you don't have the same level of stability or shareholder protections, and you're probably not going to see us invest there.

TWST: Does currency risk play into your stock evaluation?

Mr. Thrasher: It would in cases where you have the risk of a devaluation of the currency, but we tend to not invest in those areas. When you are talking about the major developed countries, we tend to focus more on the things that we are good at, which is finding great companies at good prices. I know right now the conventional wisdom is that the dollar is going to structurally appreciate over time, but I remember not too long ago when everyone thought the dollar was in structural decline. We don't have strong views on that one way or another, as we don't view ourselves as currency experts. And while the currency ebbs and flows can be fairly dramatic over short periods of time, we believe the currency impact will be small relative to the returns generated from owning great companies over long periods of time.

TWST: What about sectors? I understand you're bottom-up, but do you find yourself leaning toward certain sectors, or are you completely agnostic?

Mr. Thrasher: Similar to our geographic weightings, our sector weights are driven by our bottom-up analysis. We tend to like businesses that have a sustainable competitive advantage, are less capital-intensive, generate high returns on invested capital, have strong balance sheets and high free cash flow. Given this, we don't tend to own, for example, banks, E&P companies or companies where the competitive landscape changes rapidly. So you might expect us to be underweight financials and tech, but in fact, these are our two largest sector exposures. But sector categorization isn't important to us because it can be rather arbitrary.

Highlights

Craig Thrasher discusses Kayne Anderson Rudnick and the international small-cap strategy. The philosophy of the strategy is to buy high-quality international small caps at a reasonable price. Mr. Thrasher likes the small-cap space due to its inefficiency, which results in attractive valuations. In defining a high-quality company, on the quantitative side, Mr. Thrasher looks for high returns on invested capital and underleveraged or unlevered balance sheets. On the qualitative side, he wants a company with a sustainable competitive advantage. Mr. Thrasher invests in both developed and emerging markets as long as the particular market exhibits a certain amount of political and economic stability. He aims to hold 40 to 45 positions within the fund in order to diversify while still maintaining high conviction in his ideas.

Companies discussed: Bouvet ASA (BOUVET.OL); Accenture Plc (NYSE:ACN); Cap Gemini SA (EPA:CAP); Sopra Steria Group (EPA:SOP); Rightmove Plc (LON:RMV); Zillow Group (NASDAQ:Z) and Zoopla Property Group PLC (LON:ZPLA).

For example, we own a company called **Bouvet** (BOUVET.OL), which is an IT consulting firm in Norway. Even though it's considered technology, this is a business built on people, not technology products. So it's not something that we think has IT obsolescence. We have a number of names that are technically considered IT, but we think they don't have the same risk as a typical tech company.

to pay out all of their profits to shareholders.

By comparison, a retailer who requires new store expansion to grow can get earnings growth, but in order to get that growth, they're going to have to continue to plough most of their earnings back into the business, so they are not going to have a lot of discretionary free cash flow for shareholders. That's something we place a lot of importance on.

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1-Year Daily Chart of Bouvet ASA

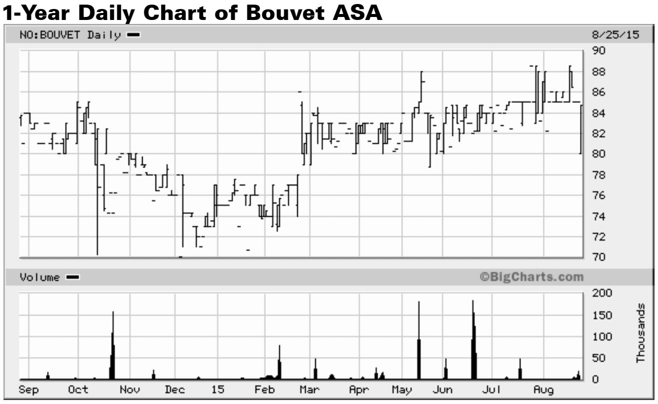

Chart provided by www.BigCharts.com

The same is true with financials. We own a variety of financials — specialty insurance companies, rating agencies, asset management firms and brokers. However, the categorization of financials has very little to do with understanding the drivers of each of these businesses. So the sector weights will vary over time, but it's not something we spend much time thinking about.

TWST: You mentioned Bouvet. Can you talk a little more about why you like that name?

Mr. Thrasher: Bouvet has a lot of the attributes that we like. Number one, it's a business where competition is based largely on factors other than price. A consultant is chosen based on reputation, expertise, relationships, etc. This helps prevent the commoditization of the business. The market in Norway is relatively consolidated with four large players — **Bouvet**, **Accenture** (NYSE:ACN), **Cap Gemini** (EPA:CAP) and **Sopra Steria** (EPA:SOP) — and Bouvet is one of the largest in Norway and the only local Norwegian firm among them, which should give them a slight edge on the competition. And if you look at their market share gains over the last several years, this would certainly appear to be the case.

Another attractive attribute of the business is that consulting, by its nature, doesn't require a lot of capital. This allows them to generate high returns on invested capital. They have an exceptional balance sheet. Probably most importantly, because the business doesn't require capital, they can grow while still paying out the vast majority of profits to shareholders. In the last five years, they have paid out over 90% of net income as dividends. The current dividend yield is 6%, and if the business grows 10% a year for the next five years, they could continue

TWST: Another name I was going to ask you about is Rightmove. Tell us about that company.

Mr. Thrasher: I've looked at thousands of companies, and **Rightmove** (LON:RMV) is one of the best businesses that I've ever seen. They are an online property-listing portal in the United Kingdom. Everybody always asks what is comparable to them in the United States, but there really is no U.S. comparable because there are some significant differences between the U.S. housing market and the U.K. housing market. But with that caveat, it's something similar to a **Zillow** (NASDAQ:Z) or **Redfin** in the U.S.

1-Year Daily Chart of Rightmove Plc

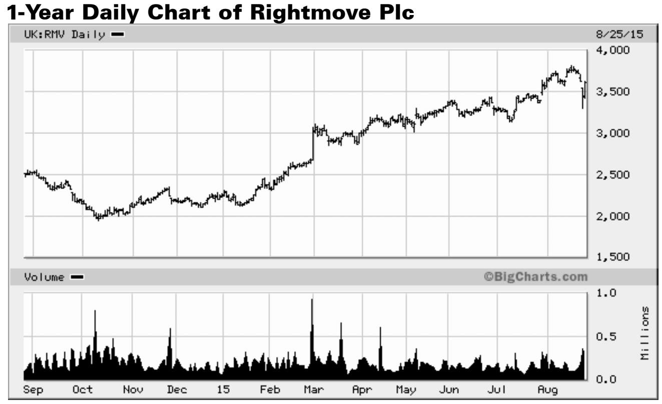

Chart provided by www.BigCharts.com

But like I mentioned, there are some pretty dramatic differences in the U.K. housing market from the U.S. market. Most importantly, in the vast majority of instances, the buyer in the U.K. does not have an agent, so the buyers do their own property searches. With no MLS, the primary search tool is the online property portals, and **Rightmove** is the dominant property portal with 82% market share in terms of page views. The number-two player, **Zoopla** (LON:ZPLA), has about 15% market share.

So effectively this is a duopoly with **Rightmove** as the clear leader. The reason for this is it is a network-effect business. Buyers are going to search where the most homes are listed, and sellers are going to list where the most buyers are. **Rightmove** dominates the market in terms of the listings for the buyers and audience for the sellers. Once this network is in place, it is self-perpetuating and very difficult for competitors to disrupt.

And in fact, this network effect was put to the test earlier this year. **Rightmove** and **Zoopla** have been raising prices every year for a number of years, and obviously, the real estate agents don't like that. So a group of them banded together to form their own competitive offering. They formed a company called **Agents' Mutual** and started a website called OnTheMarket, and their intent was to try to counter the power of **Zoopla** and **Rightmove**.

Late last year, heading into the launch of OnTheMarket, a lot of people were really worried that this was going to damage **Rightmove's** business, and the stock traded down significantly. This allowed us to build a substantial position in the company because we believed **Rightmove's** business benefited from a strong network effect and that **Agents' Mutual** was unlikely to have a meaningful impact on their business long term. And now, seven months after the launch of OnTheMarket, it is pretty clear that **Rightmove's** competitive position and business are as strong as ever.

In addition to the competitive strength, the financial characteristics of **Rightmove** are incredible. **Rightmove's** operating profit margins are over 70%. The business requires very little capital, so returns on capital are astronomical. Cash flow on average exceeds net income, and the company has committed to returning all free cash flow to shareholders, and they can continue to return all capital to shareholders even though the business is still growing at a double-digit rate.

Management's stewardship has also been exceptional. During the financial crisis, **Rightmove** was one of very few companies that actually increased their share repurchase as the share price declined. They bought back nearly 10% of their shares in 2008. And finally, they have explicitly stated they do not intend to go into other businesses or other geographies. This is an area where many successful companies run into trouble. So for all of these reasons, we really have a very high regard for **Rightmove**.

TWST: In terms of portfolio composition, do you have position size limits, and how many positions do you have?

Mr. Thrasher: We typically own about 40 to 45 positions. The goal is to have enough diversification in terms of geography and economic exposure but, at the same time, maintain high conviction in our ideas. Our initial positions are typically 1% to 5%, and we'll allow a position to appreciate up to 10%.

TWST: What conditions make you sell a stock?

Mr. Thrasher: The two primary reasons to sell a stock are: Number one, we were wrong about our thesis, and we are seeing evidence that the competitive protections that we thought were there are not there, and then secondly, valuation. Either the stock has reached a price where we don't feel that we are getting an appropriate return expectation from this point forward, or we found something else that we think is more compelling.

TWST: What is your overall outlook for the international small-cap space?

Mr. Thrasher: I think that there is a lot of opportunity in the asset class, and the reason I think that is because of what I mentioned upfront, the fact that it is a very inefficient asset class. That allows us to buy great businesses at great prices, and if you look around the investment landscape, where bonds are priced now, where equities broadly speaking are priced now, there are not a lot of high-return opportunities available. I'm not going to necessarily say that if you buy the international small-cap index, it is going to do great, but I do think that for us, buying a collection of great businesses at great prices, the outlook for us to put up strong performance over time is there. And I definitely believe that the return opportunities relative to other major asset classes are very strong.

TWST: Thank you. (LMR)

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