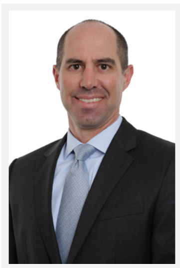
KayneCast

A Podcast Series by Kayne Anderson Rudnick



Episode 56

Third Quarter 2017 Review of the Small Cap Sustainable Growth Portfolio

Todd Beiley, CFA
Portfolio Manager & Senior Research Analyst

Hi, this is Todd Beiley, Portfolio Manager of Kayne Anderson Rudnick's Small Cap Sustainable Growth strategy. Today I'll discuss our results for the third quarter of 2017.

First, let me briefly restate our investment philosophy. There are three primary components to our approach. First, we look to invest in companies in which we can identify a durable competitive barrier that will provide for attractive profitability over time. Second, we seek to pay a fair price. And third, we focus the portfolio in a limited number of investments, which allows us to do deeper research on each business and gives us the ability to make investments only in cases where we have the highest confidence.

Now for the third quarter's results. Stocks continued to march higher in the period driven by low inflation, persistent low interest rates and improving global earnings. Our portfolio had a gain of 10.24 percent in the quarter, which compares to a 6.22 percent rise in our benchmark, the Russell 2000 Growth. Year-to-date, our portfolio has gained 29.16 percent and the Russell 2000 Growth has returned 16.81 percent. We are most focused on long-term returns, so let me provide our results over the past 10-year period. Our portfolio has returned 12.89 percent on an annualized basis over the past 10 years, which of course encompasses the 2008/2009 financial crisis. This compares to 8.47 percent for the Russell 2000 Growth. So our approach has thus far proven successful on a long-term basis.

I'll now discuss which positions in our portfolio provided the highest and lowest contribution to our results in the third quarter.

Our top contributor during the quarter was Autohome which we originally purchased in 2015. Recently, profits have increased at the company after they abandoned efforts to develop a direct-to-consumer auto sales business which had been a drag on profitability. Additionally, results in its core media and leads generation businesses have improved and the company has announced plans to initiate a dividend. Our research which included a visit to the company and its primary competitor led us to develop more conviction in this investment towards the latter part of last year, and we increased our position substantially at that time.

Our second largest contributor during the quarter was National Research Corp. The business saw its shares increase after it announced that they would eliminate a second class of shares that had been confusing the market due to the inconsistency between the dividend payouts between the class, but the equal ownership rights to the business. Effectively this was a large share back and the shares responded favorably to that announcement.

The largest detractor to our performance during the quarter was Ellie Mae. The stock declined for two main reasons. First, they reported slightly weaker-than-expected results and lowered their guidance because their refinancing activity declined quicker than expected. The other reason is that they have signed larger clients more recently and on a per user basis, they have taken longer-than-expected to begin using all of the services available from the platform.

Abaxis was our second largest detractor in the quarter. The company's shares fell due to a couple of reasons. First, there has been a competitive dislocation in the marketplace with the entrance of Heska becoming a more aggressive pricing competitor, and also Abaxis is spending more on R&D in anticipation of releasing newer products—so they are incurring those costs now but have not yet got the benefit of the revenue.

We made one new investment during the third quarter with the purchase of Emerald Expositions. The company operates about 50 business-to-business trade shows, the oldest of which dates back over 110 years. Trade shows serve as important venues to connect wholesale buyers and sellers within specific industries. They are a valuable way for buyers to evaluate new suppliers through face-to-face interaction, procure new products, identify industry trends and network with peers. For sellers, trade shows are an effective way to showcase new products to a large and relevant audience, generate sales leads and see competitive offerings. These dynamics are self reinforcing and tend to lead to a single event becoming the dominant show in a particular industry.

The economics of leading trade shows for the operator are appealing as well. In particular, the value derived from a show by the paying exhibitors meaningfully exceeds the cost of producing the show incurred by the operator. Also, deposits for booth space are received in advance of expenses incurred to host the show. The capital requirements of hosting a show are minimal and maintaining a leading shows popularity is made easier by the self reinforcing effects described before. Also we think Emerald stock is attractively priced. The company recently came public and is not widely known, has little sell side research coverage and it has a small float that likely turns off certain investors who prefer higher trading liquidity. In addition, a few of the company's shows are facing unique challenges that are hurting current business results. I don't believe any of these issues materially detract from the company's long-term prospects and we view the current price as attractive.

From a higher level market view, risk premiums across asset classes have declined. In other words, investors have become willing to take on more risk for less in prospective return. Amid this environment we are being prudent in making new investments. And in certain cases, we have reduced positions where it makes sense. For this reason, our cash level is above normal. We will use this cash as we find attractive new opportunities, but this takes some time.

So today I think the portfolio is very well positioned. I think we own very good businesses, each with very durable, competitive positions and the ability to prosper for many years, and I'm optimistic about our prospective returns.

Thank you for your time and we'll talk next quarter.