Kayne Anderson Rudnick

Thinking Beyond the Benchmark

Finding the high-quality sweet spot with the Kayne Anderson Rudnick Small Cap Quality Value Strategy

ACTIVE OR PASSIVE? So much of today's investment advice boils down to this simple, perhaps overly simplistic, question: "Should I pay for active management with the hopes of generating excess investment returns or should I 'buy the benchmark' through a lower-cost index fund?" In the race for investment returns, index investing can make a compelling case when compared with many active strategies, whose excess returns, if any, may be offset by fees.

However, for U.S. small-cap stocks, and particularly in the value category, the benchmark does not necessarily provide higher returns, as evidenced by the chart below (Small Cap Value Universe Comparison). This quartile chart shows that many, if not most, active managers in the U.S. small-cap value asset class have outperformed the Russell 2000 Value benchmark across all the time periods analyzed. Put another way, the index, representative of passive investing, underperforms over the long term, falling in the bottom half or quartile among all observable active managers in this asset class on an annualized basis.

How these active managers achieve their excess returns and what corresponding risks are taken can vary widely. Investors should pay close attention to how returns by active managers have been achieved over multiple time periods, focusing on the consistency of excess returns over time.

QUALITY OF HOLDINGS In addition to consistency, investors should review the quality of the underlying holdings in the portfolios of active managers.

In our view, the quality of the underlying businesses held in a portfolio is a key factor in the consistency of investment performance. We believe that investing in quality businesses is an important contributor to capturing greater risk-adjusted returns, relative not just to the Russell 2000 Value Index, but to the overall equity market.

By focusing on companies with protected and differentiated business models, the KAR portfolio management team creates portfolios of businesses that exhibit strong fundamental characteristics, such as a high return on equity, low debt-to-capital ratio, strong free cash flow and consistent profitability. We believe these financial characteristics are strong indicators of a company's durability and competitive position within its industry.

Quality may seem like a secondary factor during periods when the U.S. equity markets are advancing in a consistent manner and in particularly pronounced bull markets such as that seen in 2017. However, quality companies tend to stand out when equity markets correct. It is during these more difficult market environments—when investors are looking for safety—that quality counts.

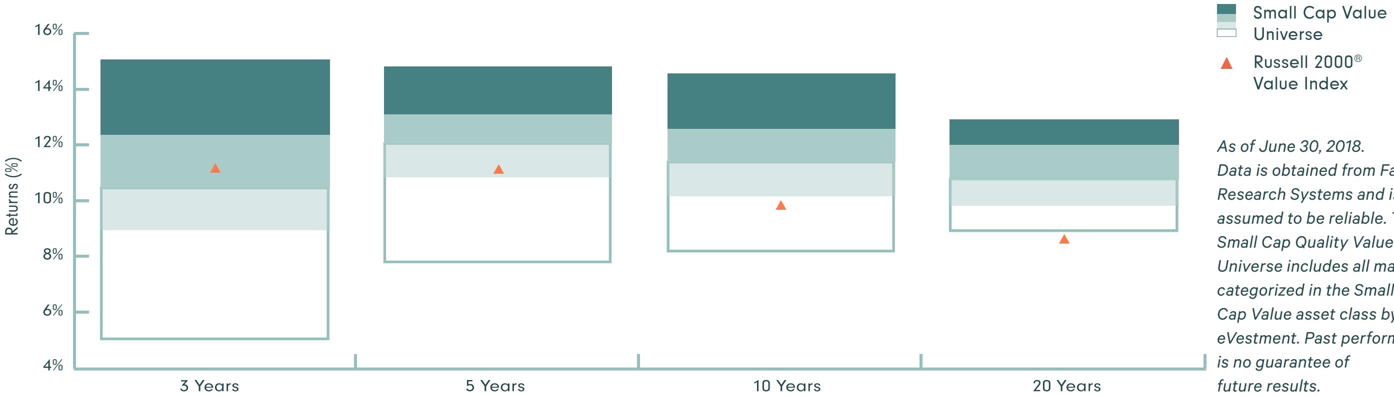
PERCENT OF UNPROFITABLE COMPANIES:

KAR SCQV
0%

RUSSELL 2000® VALUE
31%

Our mission is identifying the highest quality businesses in which to invest. Benchmarks, of course, are not built with the same discretion.

SMALL CAP VALUE UNIVERSE COMPARISON
Annualized Returns



As of June 30, 2018. Data is obtained from FactSet Research Systems and is assumed to be reliable. The Small Cap Quality Value Universe includes all managers categorized in the Small Cap Value asset class by eVestment. Past performance is no guarantee of future results.

Profiting from profitable companies

AN ANALYSIS OF ONE OF OUR ACTIVELY MANAGED INVESTMENTS—the KAR Small Cap Quality Value strategy—will provide a clear view into how the quality of underlying holdings affects the portfolio overall. The KAR Small Cap Value strategy invests in the small-company universe benchmarked to the Russell 2000 Value Index. Take a look at the following charts that compare the KAR portfolio against its benchmark and the broad stock market, represented by the S&P 500 Index.

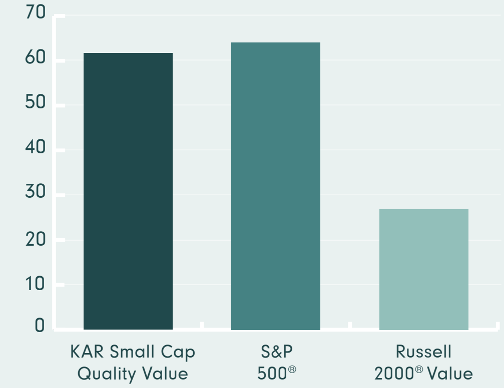
Our focus on quality gives our Small Cap Quality Value strategy stronger fundamental characteristics and, subsequently, better risk-and-reward characteristics than both the benchmark and the larger equity market.

Data as of June 30, 2018. This material is deemed supplemental and complements the performance and disclosure at the end of this presentation. Data is obtained from FactSet Research Systems and BNY Mellon and is assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. Past performance is no guarantee of future results.

WHAT'S IN YOUR INVESTMENT PORTFOLIO?

HIGH-QUALITY STOCKS

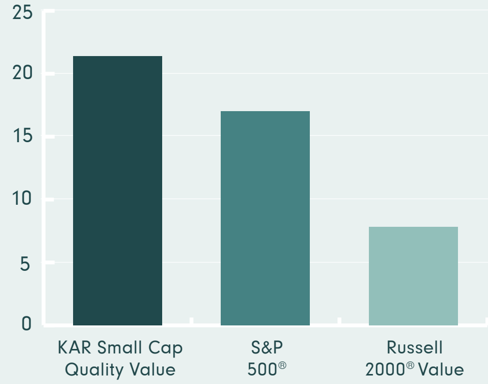
Percentage of holdings with S&P Quality Rankings of B+ or higher



Getting the benefits of small company exposure with the quality level in line with that of the large-cap universe.

PROFITS

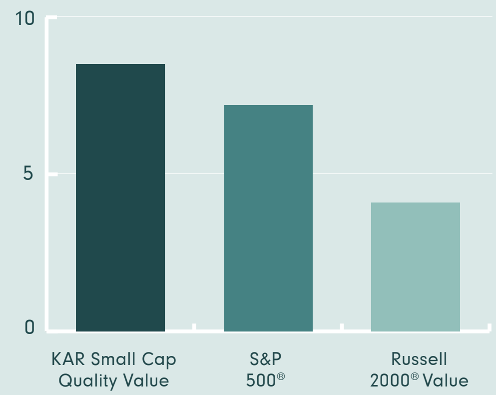
Five-year return on equity



Profitable companies produce better returns and are more likely to sustain in volatile markets.

DEBT COVERAGE

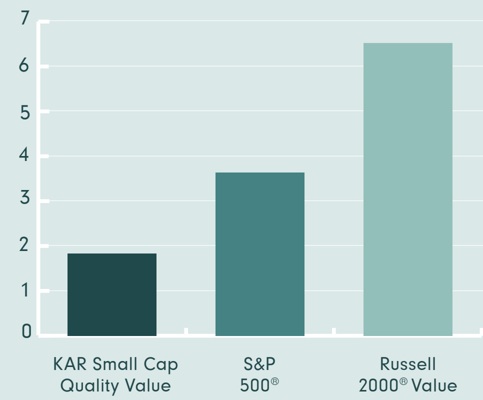
Interest coverage expense ratio



A higher interest coverage percentage means companies can more easily pay their debts.

DEBT

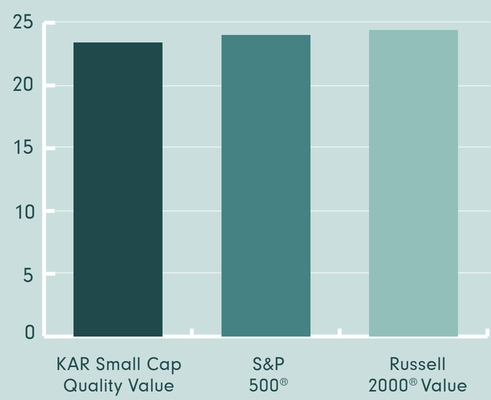
Total debt/EBITDA



Less debt translates to more free cash flow to fund future growth.

VALUE

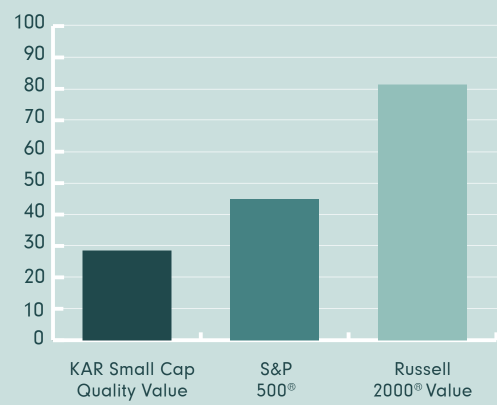
Trailing 12-month price-to-earnings ratio



Stocks with lower P/E ratios trade at a relative discount and have room to grow.

VOLATILITY OF EARNINGS

Earnings variance for the past 10 years



Lower earnings variance indicates companies have more predictable earnings over time.

Managing risk to keep investors on course

THE FLIP SIDE OF RETURNS IS RISK, and careful risk management is a key contributor to how the KAR Small Cap Quality Value strategy has been able to consistently outperform its benchmark. The small-cap asset class is generally known for its potential to deliver excess returns over the large-cap space, but it is often understood to be carrying more risk. Our portfolio management team maintains its sharp focus on quality in approaching and managing portfolio risk; as such, the risk profile of the KAR Small Cap Quality Value portfolio is closer to that of the S&P 500 Index, which comprises U.S. large-cap companies, than it is to the Russell 2000 Value Index, which tracks U.S. small-cap companies.

Investors often describe risk as the potential to lose money. The Small Cap Quality Value portfolio, across its 19 full years of history, has had more years of positive returns and fewer years of negative returns than has the benchmark.

ANNUALIZED RETURN	
KAR Small Cap Quality Value	11.97
S&P 500®	6.65
Russell 2000® Value	8.60

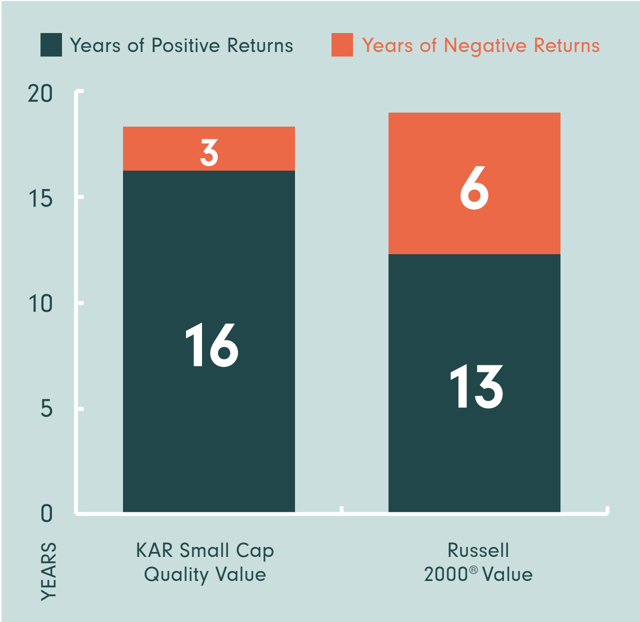
BETA	
KAR Small Cap Quality Value	0.76
S&P 500®	0.65
Russell 2000® Value	1.00

Lower beta indicates less volatility than the market as a whole.

STANDARD DEVIATION	
KAR Small Cap Quality Value	15.82
S&P 500®	14.82
Russell 2000® Value	18.01

Lower standard deviations indicate more consistent returns over time.

Data presented is since the inception of the KAR Small Cap Quality Value strategy, June 1, 1998 through June 30, 2018. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.



A concept in behavioral finance known as prospect theory tells us that investors feel the impact of negative returns more deeply than positive ones. At KAR, we strive to remain defensive even in the worst markets.

Undeniable performance through the years

> Instead of "active or passive?" investors would do well to ask themselves "high quality or low?"

AT THE END OF THE DAY, investors want an investment strategy that delivers returns, through bull and bear markets, recessions and recoveries. The below graph depicts how a $1 million invested in the KAR strategy at its beginning would have performed over the long term. As of June 30, 2018, the investment would have grown to $9.7 million and $7.9 million with fees. Those numbers compare with $5.2 million in the Russell 2000 Value Index and $3.6 million in the S&P 500 Index. It is clear that, even with fees, the KAR strategy's growth is significantly greater than gains found in market indices.

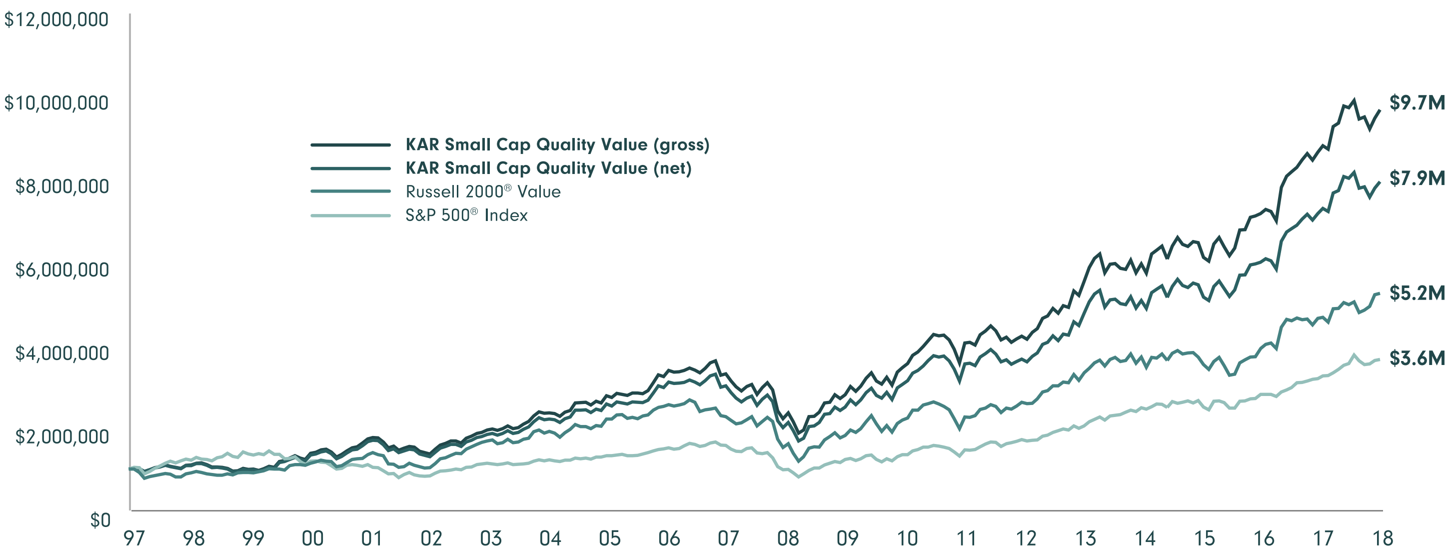


Chart reflects cumulative returns since the inception of the KAR Small Cap Quality Value strategy, June 1, 1998 through June 30, 2018.
This material is deemed supplemental and complements the performance and disclosure presented below. Past performance is no guarantee of future results.

DISCLOSURE Kayne Anderson Rudnick Investment Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Kayne Anderson Rudnick Investment Management, LLC has been independently verified for the period from January 1, 1999 through December 31, 2016.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. The Small Cap Quality Value Composite has been examined for the period from January 1, 1999 through December 31, 2016. The verification and performance examination reports are available upon request.

Kayne Anderson Rudnick Investment Management, LLC, a wholly owned subsidiary of Virtus Investment Partners, Inc., is a registered investment advisor under the Investment Advisers Act of 1940. Registration of an Investment Advisor does not imply any level of skill or training. Kayne Anderson Rudnick Investment Management, LLC manages a variety of equity and fixed-income strategies focusing exclusively on securities the firm defines as high quality.

The composite includes all fully discretionary institutional and pooled Small Cap Quality Value Portfolios. Small Cap Quality Value Portfolios are invested in equity securities with capitalizations consistent with the Russell 2000® Value Index, that have market control, rising free cash flow, shareholder-oriented management, strong consistent profit growth and low-debt balance sheets. For comparison purposes, the composite is measured against the Russell 2000® Value Index. The Russell 2000® Value Index is a market capitalization-weighted index of value-oriented stocks of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total-return basis with dividends reinvested. Benchmark returns are not covered by the report of independent verifiers. The composite was created in June 1998. Previously, only institutional accounts were included.

A list of composite descriptions and policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

Prior to January 1, 2011, the composite minimum was $250,000. As of January 1, 2011, the composite was redefined to include both institutional and mutual fund [or pooled] accounts. Prior to January 1, 2011, accounts that experienced a significant cash flow, defined as aggregate flows that exceeded 25% of the account's beginning of period market value, were temporarily removed from the composite.

The standard management fee schedule currently in effect is as follows: 1.00% for the first $25 million; 0.80% on the next $25 million; 0.70% on the balance. Actual management fees charged may vary depending on applicable fee schedules and portfolio size, among other things. Additional information may be found in Part 2A of Form ADV, which is available on request. The performance information is supplied for reference. Past performance is no guarantee of future results. Results will vary among accounts. The U.S. dollar is the currency used to express performance. Returns are presented net of transaction fees and include the reinvestment of all income. Gross returns will be reduced by investment management fees and other expenses that may be incurred in the management of the account. Model net returns have been calculated by deducting 1/12th of the highest tier of the standard management fee schedule in effect for the respective period from the gross composite returns on a monthly basis.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns for accounts in the composite for the entire year. For those years when less than five accounts were included for the full year, no dispersion measure is presented. The three-year annualized ex-post standard deviation measures the variability of the composite (using gross returns) and the benchmark for the 36-month period ended at the following dates:

3-Yr Annualized Standard Deviation (%)		
December 31	Composite	Benchmark
2011	21.64	26.42
2012	16.24	20.17
2013	14.50	16.05
2014	13.06	12.98
2015	13.94	13.65
2016	14.30	15.72
2017	12.32	14.17

The Russell 2000® Value Index is a trademark/service mark of Frank Russell Company. Russell® is a trademark of Frank Russell Company.

Year	Total Firm Assets ($ Millions)	Total Composite Assets ($ Millions)	Accounts at Year End	Gross Annual Return (%)	Net Annual Return (%)	Russell 2000® Value Index Annual Return (%)	Internal Dispersion
2008	3,445	64	68	(28.51)	(29.26)	(28.92)	0.56
2009	4,010	71	66	26.97	25.73	20.58	0.80
2010	4,729	98	77	25.10	23.88	24.50	0.60
2011	5,232	521	106	6.57	5.54	(5.50)	0.48
2012	6,545	474	120	9.97	8.87	18.05	0.35
2013	7,841	646	142	41.06	39.72	34.52	1.05
2014	7,989	581	149	3.05	2.00	4.22	0.52
2015	8,095	535	151	(0.16)	(1.16)	(7.47)	0.20
2016	9,989	711	141	26.74	25.50	31.74	1.13
2017	14,609	996	191	20.48	19.30	7.84	0.53

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800.231.7414