KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 61

Second Quarter 2018 Review of the Small-Cap Core Portfolio

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Jordan: Hello and welcome to Kaynecast for the second quarter of 2018. This is Jordan Greenhouse, Client Portfolio Manger at Kayne Anderson Rudnick.

Jon: Hi, this is Jon Christensen, Portfolio Manager for Kayne Anderson Rudnick small-cap core portfolio.

Jordan: Jon let's start with the review of the small-cap core portfolio for the second quarter. Can you take us through a broad market overview related to the small-cap market place in addition to taking us through some of the key contributors as well as the detractors for the portfolio.

Jon: Sure. So when we look at the second quarter of 2018, the Russell 2000 index our benchmark was up almost 8 percent so very strong quarter overall. Certain sectors such as energy, consumer staples as well as healthcare in addition to REIT's were all up double digits, at least. So I would describe the quarter as far as the market overall as more of a lower quality quarter. You look at different attributes such as S&P stock ranking, betas, high debt on the balance sheet. Those types of businesses typically did better in the quarter. Obviously as I've pointed out, energy had a very nice quarter, up over almost 21 percent. So we don't own a lot of energy companies so that is going to be a little bit of a headwind for us. Healthcare I thought was interesting as well in that is was up 10 percent but a lot of companies that have lower S&P stock rankings within healthcare did better than those with higher S&P stock rankings and also with consumer staples as well. Lower quality consumer staples did better than higher quality consumer staples. So I would just describe the overall quarter as one a more of a lower quality headwind for us albeit over one quarter, we really don't look at that as a long period of time but when we do look at from the quarter overall, it was definitely much more of a lower quality quarter.

Jordan: In looking at the second quarter's performance we saw a strong move in the energy sector. However, when looking at the small-cap core portfolio we do see a current underweight. Can you describe your views on this space in addition to how you look at investing in the energy sector.

Jon: Yeah as I said, energy was a very strong contributor obviously in the quarter as a sector overall. We don't own a lot of energy companies typically and that's been fairly consistent over our history. Not to say we don't own any in small-cap core. We do have 2. Core Labs as well as Drill-Quip but in general we don't like the sector because of the fact that it usually is tied to commodities and they're usually capital intense businesses. Now we feel like we have some unique businesses with Core Labs as well as Drill-Quip in that they have a tendency to be a little less capital intensive, a little more proprietary in terms of software services that E&P companies find valuable when looking at not only new drilling areas, but also older drilling facilities that may be reengaged and they're looking for geological data to see how much productivity they can get out of a certain well area and that's where a company such as Core Labs does very very good job with. So those companies tend to be less capital intensive, but in general there's not a lot of Core Labs or Drill-Quip's out there so we will probably perpetually be underweight energy, going forward and no expectations for us to increase our position at this time.

Jordan: There has been an increase in the average market cap of the portfolio over the recent years. Can you walk us through how you monitor the average market cap, in addition to that can you walk us through some of the opportunities you're seeing in the small-cap space.

Jon: It's absolutely true that our average market cap has increased in small-cap core overtime. It's really a characteristic of a couple things happening and one is that we have had several businesses, it's a nice problem to have I guess, we've had several businesses that we bought in that 1 to 3 billion market cap range that are now 10 billion dollars plus. So we've held these stocks for many years and they've done very well for us. So what we're trying to do and what we think about is too is we try not to own any market caps that are larger than that, than the largest market cap within the Russell 2000 index and right now that's around 10 billion dollars. So when a stock does hit that 10 billion dollars plus area for us it will become a candidate for eventually leaving the portfolio. This does not happen overnight, this is not a knee-jerk reaction but it is something that eventually will make an exit out of the portfolio and what we try to do with that in those cases is when those higher market caps exit, we then try to find other names in the portfolio to replace them that are in, again, in that 1 to 3 billion dollar market cap range. So because of the low turnover, the 20 to 25 percent turnover we perpetually have in this portfolio, we are going to have a higher market cap than the benchmark just kind of in perpetuity and remember that the Russell 2000 reconstitutes every June and July. We don't reconstitute so we keep our stocks in there. So it's our goal in the end to maintain the integrity of the portfolio, we're not here to run a mid-cap portfolio, we're here to run a small-cap portfolio, but again, because of how we do things in our low turnover we will be a little bit higher than the average weight of market cap of the benchmark, but again, our goal is to continually rejigger our older, higher market cap names and put it into smaller market cap names and that's indeed what we've done but I think people need to be patient because this does not happen overnight and that's why we take a multi-year approach when we're doing the average on these so we can kind of weigh that out over time but over time we will keep it down. It will be a little bit higher than the benchmark but we're ok with that given the way we invest.

Jordan: One of the recent additions to the small-cap portfolio has been Moelis. Can you explain your rationale and the potential opportunity set in moving forward with this business?

Jon: Sure. So Moelis is a name we added to the portfolio late last year. They are a global investment bank. They provide financial advisory, restructuring, capital raising services to clients all over the world. We like these types of businesses because they are really human capital intensive in nature so they're not capital intense businesses structurally but because they have that high human capital it's a nice variable cost. So these are teams when they're going out and doing investment deals who are not paid just on commission but they're paid on their team approach which it's a very unique culture in Moelis and a lot of promotion from within where there are other investment firms try to buy investment teams from other groups and other organizations. Moelis has really focused a lot on internal promotion and over time in making it a very team approach. We think this reputation in the culture of the business kind of providing this unbiased advice to clients really pays off in garnering business and maintaining business and getting recurring business over long periods of time. Unlike some of the other bulge bracket firms and banks, Moelis doesn't have any other lines of business that can create possible conflicts of interests with other clients. So for us this is a company that has grown sales at a 19 percent CAGR over the last 7 years while growing EBIT at an even faster pace of 34 percent at the same time period. So they have very low debt on the balance sheet, again that low capital intensity that business converts into high, strong free cash flow and we think that this is a company that will continue to have productivity from its managing directors and in this favorable environment we think we'll do very very well.

Jordan: Kayne Anderson Rudnick tends to take a long term view on its holdings with turnover averaging approximately 20 to 30 percent. We also notice many of the positions within the portfolio are held in excess of 5 years. Can you explain your sell discipline and monitoring process for this portfolio?

Jon: Yeah I think understanding our cell discipline is just as important as understanding our whole buying procedure as well because selling you can get the sells wrong and leave a lot of money on the table and if you get the sells right obviously it's very additive to alpha. But here's how we think about selling in general. There's a lot of different reasons why you might sell a business.

For example, one could be it gets acquired by another business, maybe the valuation can get a little bit high, something has changed in the business and I think that last reason is the main reason. So the main reason we would sell a business is something has changed in the competitive structure of the business or maybe we misidentified it at the start but usually it's a case of we find a company and they've got this competitive mote that we admire and then over time something has eroded. Either they've deviated from that path, maybe they've gone off and made acquisitions that are totally not even close to their core competency or the competitive environment eventually caught up to them either through management missteps or again other people encroaching on their space. Our job is to make sure that when we first work on a business that we identify the transitory versus structural issues. That's why we really need to do hard work and research on these businesses. We need to understand that when a company has weakness is this a structural issue or is it a transitory issue? If it's a transitory issue then it can be an opportunity for us to add to our position if it's weak right? But if it's a structural issue it's usually going to mean that we are going to sell the business.

Jon: So that's why in the end we need to understand the business as well to identify those structural versus transitory issues.

Jordan: Jon can you take us through the quarters performance as well as some of the key contributors and detractors for the portfolio?

Jon: Yeah. So when you look at the market overall in Q2 2018, it was an interesting market in that the Russell was almost up 8 percent overall. So a very strong quarter for the Russell 2000 and there were certain sectors that participated very well in that. Energy was up over 20 percent. Consumer staples was up 14 percent. REIT's were up 13 percent. Healthcare was up 10 percent. When you dig down a little deeper into it, it was a little bit, I would call a little bit more of a lower quality market and what I mean by that is stocks that had very low S&P stock rankings did very well in the quarter. Stocks that had P/E's did well in the quarter. Stocks that had more debt on the balance sheet had a tendency to do a little bit better in the quarter. So overall I would say that it was a little bit more of a lower quality quarter. I thought it was interesting too. If you look at just the sectors I called out a second ago, like within energy up over 20 percent, those stocks that had S&P stock rankings of B or lower were up 22 percent but stocks that were B+ or higher were down almost 10 percent so a huge difference there in low quality versus high quality. Same thing with healthcare. Lower quality did better and same thing with consumer staples so in those sectors that did very well there was a clear delineation that lower quality stocks did much better in the quarter. So we had that headwind albeit over one quarter, but it was still a headwind for us given the market I just described. Some of the top performers we had in the quarter, Auto Home, Rightmove, an Aspen Technology. Auto Home which is one of our larger holdings, they are a China based website, multiple websites focused on the consumer automotive industry. This is the company that continues to grow revenue in that 25 to 35 percent range with earnings growing even more than that. So they're continuing to do well and then on the bottom side we had HFF was one of the leading detractors, WABCO as well as MarketAxess. HFF real quick, they are a broker in U.S. commercial real estate. They had reported some volume weakness for their Q1 number actually so the stock was taken down a little bit. This is always a tricky situation because the stock was actually up around 77 percent in the previous 12 months, so it had a very good run and just reported a little bit of weakness in volume so investors took some profits at that time, we look again at those structural issues versus transitory issues and we view this as a transitory issue in HFF and we continue to be share holders in that stock.