KayneCast

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Episode 62

Market Review Second Quarter 2018

Douglas S. Foreman, CFA
Chief Investment Officer

Jordan: Hello this is Jordan Greenhouse, Client Portfolio Manager, with Kayne Anderson Rudnick.

Doug: This is Doug Foreman, Chief Investment Officer at Kayne Anderson Rudnick.

Jordan: Doug, thanks for setting aside the time today. What we're really going to do is focus on a brief recap of the second quarter for 2018. Can you start out by giving us a little bit of an overview of some of the changes, some of the factors that drove the market and the overall performance?

Doug: Well Jordan, I think the biggest thing that happened during the second quarter was that we started a transition from the global synchronized recovery that we were clearly in at the beginning of 2018 to now a more bifurcated market where the U.S. has continued to do very well economically but a lot of foreign markets, both developed and emerging markets, have slowed down fairly appreciably since the beginning of the year. So what you're seeing is the S&P has managed to eek out a decent gain year-to-date of about 2 1/2 percent. Small stocks, which are relatively immune to a lot of these foreign markets and trade issues that have cropped up, have done even better. They're up almost 7 1/2 percent year to date. But emerging markets have actually been hit pretty hard. Both debt and equity markets have declined for the year. I'd say the biggest factor was tariffs and trade talk really escalating during the second quarter which has really caused some pause, I think, in business conditions around the globe. Not so much in the U.S., but certainly in Europe and China and a lot of other emerging markets.

Jordan: Doug, building on your comments related to trade relations and the impact on both the domestic and global markets, can you take a minute to maybe talk about how this impacts Kayne's portfolios and our views on that moving forward?

Doug: Well Jordan, as you know, we focus on the long-term competitively-advantaged, high-quality businesses. So in general, most of our companies don't have a lot of exposure to heavy capital goods and heavy raw material cost and input cost that are really being affected by these trade tariffs. Items such as steel, aluminum, and freight costs. We are seeing some pressure in some of our industrially oriented businesses. Their input costs have been going up this year because of the impact of these tariffs. But we don't have a huge exposure to the automobile industry or a lot of other heavy capital-intensive areas that are really getting hurt by this more than others. So, we haven't had to change a lot of our positioning in the portfolios because of what's happening out there. It clearly is having an impact on the economy, I think, overall, which has been negative. I think that's pretty universally understood. But our positions tend to be relatively well-insulated from these effects and I think we're also seeing that in the small-cap index itself which, as I mentioned earlier, has done extremely well year-to-date.

Jordan: Another area that people are talking about a lot is related to Fed commentary. It's very clear that the economy, at least domestically, continues to improve overall. GDP growth continues to look very attractive and the Fed continues to look at opportunities to raise rates. With this in mind, we see very little movement on the long end of the curve. Can you discuss your views related to this and where investors should be focused?

Doug: Sure, Jordan. I think the biggest thing that most investors don't understand is there's been this universal mantra of, "interest rates are going up. Interest rates are going up," and the reality is the only interest rates that have been going up are short-term interest rates, which is the only thing the Federal Reserve actually controls. The Fed does not control the long end of the curve. The long end of the curve, in my opinion, is mainly priced off of inflationary expectations in the future. What we've seen is, while inflation has gotten to the Fed's target of two percent, it's still just barely above that after ten years of priming the pump and trying to get there. So inflation seems to be relatively well contained. Labor is tight, material costs have been going up, etc. but we still have fairly low levels of inflation. So I think that's what's driving the long end. I am concerned whenever we get an inverted yield curve. Historically, an inverted yield curve has been the single best predictor of future economic activity, i.e. recession, better than any economist or strategist or money manager, for that matter. So I do respect and pay close attention to that. The yield curve has clearly flattened and it is concerning. However, I would point out to people that the yield curve was flat essentially from 1994 to 1998. There was a four year period where it was just flat across the board. Stocks did very well. There was no particular problem and the economy managed to do fairly well during that time period as well. So there is precedent for it to flatten and stay flat for quite a while. We'll see what happens in this case, but an inversion, unlike what Fed chairman Powell seems less concerned about, I am more concerned about an actual yield curve inversion if and when it occurs. I do think it will be a very stern warning that the Fed is pushing too hard on the short end.

Jordan: Looking back at the first six months of 2018, domestically you do see positive returns all across the equity markets. However when we look at the international area as well as the emerging markets, we notice from a performance standpoint there have been some distinct struggles. Can you talk about Kayne Anderson Rudnick's current exposure and where you're seeing potential opportunities in the global area?

Doug: Well, Jordan, I think that if you look at the international marketplace, we have an international small-cap strategy that focuses on international small-cap companies and what we're seeing there is valuations are much cheaper than what they are domestically. Business conditions, as I mentioned earlier, aren't quite as strong but in the small-cap arena, overall business conditions are a lot less important than they are to large-cap companies in these different areas. Good small cap companies should be able to grow and prosper and do well even in less sanguine times in terms of economic growth. So we're still finding plenty of opportunities in our international small cap and our emerging small cap portfolios that find attractively valued, less than 20 time earnings companies that are growing their earnings at a solid double digit rate even in a less than desirable economic environment right now for many markets around the globe like Brazil and Russia and Turkey and a few others that are in the headlines these days.

Jordan: Another topic that comes across the news very frequently is the idea of taking a passive versus an active approach and when you look at net flows across the industry, what you see is enormous flows going into the passive space. Especially for the large-cap area as well as the small-cap market place. Can you take a moment and discuss your views, both on active and passive, to meet this debate? In addition to that, expand possibly on why the mid-cap sector of the market or mid-cap asset class appears to be such an overlooked area?

Doug: Jordan, I think in terms of the active versus passive debate, first of all, most of the academic studies that have been done on this really focus on the large-cap equity space. What I would point out is that if you take thousands of managers that compete in the large-cap space, which have been present since the early 80's and in the 70's in this business, when you take a large number of statistical players and you subtract out their one to 1-1/2 percent management fees and you compare their average return to a no-fee index fund, of course they're going to lag. The average manager will lag, by definition, because it's the average which is going to be the average of the index because you've got thousands of managers. If you had a smaller data set, you might get a completely different outcome. But when you have thousands of people in the data set you're going to get an average return and then you're going to subtract out their fees and lo and behold, you're going to find out they trail the unmanaged index fund which has no fees. That's hardly surprising and shouldn't be surprising to anybody. It doesn't mean active managers, even in the large-cap space, can't add value over long periods of time. It just means that the average manager, when you have thousands of them, isn't going to do that and I would totally agree with that. So I think in many other areas outside of the obvious large-cap area, most of this indexation hasn't been proven one iota over long periods of time. So people have taken an idea and run with it in a variety of different areas and have been very successful.

Doug: Now all that being said, our business and any active manager today, and this was true when I started in the business in 1986, if you can't prove that you can add value over a benchmark over long periods of time, -reasonable periods of time then clients should, and will, go buy passive products and so the lifeblood of an active manager like ourselves is our proven ability and continued ability to generate alpha for our clients. That's how we earn our keep and that's how we earn our fee and if we don't do that then we don't have a business. So in mid-cap, why is that overlooked? I think it's overlooked because a lot of institutional investors, particularly consultants and others that study the equity market, believe that their large-cap managers own a fair number of mid-cap names and their small-cap managers let some of their winners run so they own some mid-cap names. So therefore they feel like they feel like they've got the mid-cap asset class covered. I will tell you that the Morningstar data that Virtus and others have looked at would indicate that the mid cap equity portions of the U.S. market today is about a third of the market overall and the average investor has about a 17 percent weight. So while it may be true that their small-cap managers own a few mid-cap names and their large-cap managers own a few mid-cap names, they're still about half-weighted in a class of stocks called mid-cap companies that are really in the sweet spot of their corporate development. The beauty of mid-cap stocks is that they're past the startup stage, they're past the business model, trying to figure out how they're going to get paid, how they're going to monetize whatever they've created, how they're going to produce whatever they've created in some cases, and how they're actually going to make it and manufacture it. They're past that point and they're still at a very young age where they have lots of opportunity to take market share and grow at a very high rate for a fairly extended period of time and they're not big companies where they have to worry about maturity, the law of large numbers and simply getting too big and too bureaucratic and hitting a wall in terms of growth opportunities because they simply get so successful that they become victims of their own success over time. So we think it's a great area in the U.S. equity market. In fact, if you look historically at the numbers over the last 20 years, you get some of the best returns out of any asset class in the mid-cap area, so it's an area that people overlook and they really shouldn't.

Jordan: Thanks for that answer, Doug. The last question I have is, Kayne Anderson Rudnick in general is known as a quality manager. Can you take a moment and explain what we mean by quality, why this is an important metric to consider, and lastly, how you feel this plays an important role in the current rate environment being almost 10 years into a bull market?

Doug: Sure. Well I think the key thing number one is that quality to us is a qualitative characteristic. We have all the quantitative metrics that one would look at for a quality business. Things like high ROE, low levels of debt, positive cash flow, self-sustaining businesses over time. We have all the financial metrics that you would look for but unlike a lot of other investors that that's where they really stop when they're trying to analyze a company and they've determined that it's got quality returns so it must be a quality business. To us, we spend more time on the business itself, which is a qualitative assessment of what protects and allows the business to be competitively advantaged over long periods of time so that it can sustain the quality characteristics and importantly, the quality financial characteristics that they're currently producing. They cannot sustain that if they don't have adequate protection from competitors because this is Capitalism and in Capitalism 101, if you're making a lot of money and you're a very successful company there's going to be people that attempt to replicate that because they'd like to get rich as well. So it's our job as investors to sit down and make sure that we've assessed that when people try, they're going to fail for one reason or another-whether it's high switching costs or brand or a network effect or a low cost position-that that there's some sort of business model that we're familiar with, that we believe in, will protect that business from competition and allow it to sustain its profitability and grow profitably over long periods of time. So it's really that qualitative analysis where we spend our time, where we earn our keep and really what differentiates us from other investors. Because most other investors, quite frankly, use the numbers-the numbers tell them all. They spend all their time looking at the numbers and they don't really understand the business. We know this because we interview a lot of people-we've just hired several analysts recently and it's amazing when we go outside and talk to people that have been in other firms for quite a while, it's very difficult to find anybody that even understands what we mean by quality. Everybody says quality and everybody in this business talks about quality in their portfolio. Nobody comes in and says I own a low quality portfolio and pray these stocks go up. But what people define as quality is really a lot different than what we're discussing here.

Jordan: Thank you again, Doug, for your time. We really appreciate the feedback and look forward to the next quarter's updates,

Doug: You're welcome, Jordan. Thank you.