KayneCast
A Podcast Series by Kayne Anderson Rudnick

Episode 60

Second Quarter 2018 Review of the Small Cap Quality Value Portfolio

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

Craig: And this is Craig Stone core portfolio manager of the small-cap quality value portfolio.

Jordan: Craig what I like to review is Q2 2018 small cap value portfolio. If you could provide us with an overview of the overall strategy in addition to some of the key contributors as well as the detractors during the quarter.

Craig: Sure, Jordan. So during the quarter we underperformed relative to the benchmark and there was a couple of stocks in our portfolio in particular that led to the lower contribution that we've had in the quarter. We run a fairly concentrated portfolio of roughly 30 stocks so during any short period of time like in a quarter where two or three of our companies report disappointing earnings or have company specific news that come out that leads to decline in the stock price. That can lead to have under-performance in a period. I would also say that during the second quarter we also saw a reversal of what we saw last year in that we've had particular quality headwinds that did not help us in terms of our relative performance. What I mean by that is that if you look at last year in 2017, the companies in the benchmark that had high returns on capital significantly outperformed companies with negative returns on capital (negative ROE's). Meaning that these companies were unprofitable. Those unprofitable companies had negative returns. Fast forward to this year particularly starting in the second quarter we saw was a reversal of that in that high returns on capital businesses actually had negative performance versus negative ROE companies that had positive performance so we had a direct reversal of that. Having said that, at the end of the day stock selection is going to drive our return either on the upside or the downside relative to the benchmark because we are really buying the high quality businesses that we want to own for the long term and like I said, if two or three stocks in the quarter in a short period of time does not do well for us, we will under-perform. Conversely if two or three stocks that does well for us, as we've had in other periods, we can outperform significantly as well.

So let's talk about the couple of stocks, the top contributor list, first for the quarter and then I'll get into the two stocks in particular that ended up hurting us in the quarter in terms of under-performance. The two stocks that really helped us in the quarter was MGP or MGM growth properties. This is the company that is a real estate investment trust that owns the underlying properties for the MGM Grand. Most of the properties in Las Vegas on the Las Vegas strip. It's a very unique structure and it's a very good business and this is a new holding for ours that we've had since the middle of last year. The other top contributor is National Beverage, which is really the owner brand of La Croix sparkling water. This is a fast growing business that has taken the La Croix brand to the number one market share position in the U.S. today. We expect that this company will continue to do well as the health conscious or the switching from the carbonated soft drinks into healthier alternatives is directly benefiting La Croix.
On the other side, the two stocks that have hurt us the most in the quarter. First we have HFF under ticker symbol HF. This is a business that is a transaction, volume, advisory business that helps real estate investment trusts, pension funds, sovereign well funds, anybody who is invested in the real estate asset class help them with discovery of price, debt placements and other issues

related to transactions. What's unique about HF and unlike their competitor is that HF does not have internal management of properties, does not have a portfolio of their own properties so therefore, there's no conflict of interest with their clients. Like I said unlike their competitors have sometimes internal management or portfolios. This unique structure gives HF the ability to attract and retain top talent who can go out and just provide advisory services to their clients and not have to worry about that conflict of interest. It's a very unique structure and we like that. What hurt them in this quarter is that HF reported a decline in transaction volume which is the first time they've seen in a couple of years. We think this is a temporary issue and not a long term issue in that typically when you hit a patch where commercial real estate prices are starting to soften in certain markets and that happens over time the price gap between sellers and buyers causes a momentary pause in real estate transactions. But over time what we're seeing is that price has a less effect on HF's business and it's more about transaction volumes. Volumes we believe will become steady and increasing over time and as soon as those price gap between sellers and buyers converge as we have seen in the past cycles. So we're still long term share holders and we'll continue to hold the position.

Craig: The other stock in the portfolio that caused low contribution relative to the benchmark is Anika Therapeutics. Anika had a couple of issues in the quarter. One was that they announced a voluntary recall of a product, but that was only 3 percent of their revenues and it has nothing to do with safety issues or the efficacy of that product and more along the lines of that they found that through their internal discovery that shelf life of these products was not as long as expected. Again, no safety issues or efficacy so it was a voluntary recall but it was only 3 percent and that was not the biggest issue for them. What really happened later for the stock that caused this sharp decline was they have a prospect, a drug that was in phase 3 trial called Cingal. Which has already been previously approved and selling well in Europe and Canada. Unfortunately this phase 3 trial current results (it's not completed yet) has shown that the combination of the product between, the injection for knee and hip joints along with steroids combination didn't really prove statistically different than just having a single steroid injection, but like I said, we're trying to sort through the data and that it's baffling why in Europe and Canada you've had the same product that's been approved and selling well and the reports from the patients has been that it's offering longer relief and very good relief but yet the phase 3 trial data is showing something a little bit different. So we're trying to sort through that, but in the mean time this company still has a core product called Monovisc and Orthovisc that is 40 percent market share in the U.S., that is highly profitable. In fact in todays current market cap, 30 percent of that market cap for Anika today is cash so there's no issue of this company having a liquidity issue or a permanent loss of capital. For us it's all about trying to figure out whether Cingal can get approved, and if it can get approved what sort of labeling issues around that, and if they can't get approved, can this company still have success in Europe and Canada without that. In the meantime, we're holding onto the stock. The stock has actually done fairly well at bouncing back this month. Like I said, 30 percent of the market cap is in cash so the company is not in danger of going out of business or anything like that even from a failed phase 3 trial. In the meantime we're holding onto that and sorting through more issues that we can figure out.

Jordan: Thank you. One of the detractors during the quarter was HF. Would it be possible to walk through some of the attributes of what you like about this business and maybe also explain from a risk management standpoint your views on this holding currently.

Craig: Sure. Real estate investment trust is a large part of the Russel 2000 value benchmark. We don't particularly like a large part of the market given that one, there was lack of valuation opportunities. People had been using REITS in the last couple of years is a substitute in driving up the valuation. In addition we typically like businesses that are high capital earners and are doing so off of a low leverage balance sheet or much more clean balance sheet than we typically find in real estate investment trusts. Not that we don't own anybody, like I said, MGP was one of our top contributors. But HF we think of as sort of a commercial real estate proxy for real estate investment trusts and what they do is they're an advisor to REITS, to pension funds, to sovereign funds where they're helping these entities transact in the market place. Both through price discovery and also through debt financing and other market insurance. What's unique about HF is that unlike their competitors, they do not have a conflict of interest meaning that they don't manage properties, they don't hold a portfolio of properties. Therefore they're truly an independent advisor to the clients so there's no conflict of interest. When you look at HF their returns are about twice that of their main competitors so they can attract top talent to join an organization and really have the ability to advise clients and like I said that lack of conflict is very important and really endears the top talent to the firm.

Jordan: Thank you very much. Another area is Kayne has always really hung their hat on a focus on high quality differentiated businesses. But periodically specifically to the value portfolio people ask from a Morningstar stand point why at times the portfolio screams as more growth oriented. Can you possibly take us through that and maybe describe some of the characteristics that affect that.

Craig: Yeah. I think that's a great question because I think often we get asked this and why we are looking like more of a core growth fund rather than a value fund. First I would say that we manage value very differently than your typical deep value manager.

Craig: We're looking for businesses that have high returns on capital that can sustain or resist the reversion to the mean to become a me too company through the competitive advantage and structural advantages that they have. While your typical devalue managers coming from the opposite end where they're looking for broken businesses or companies that are not doing well and generating far below average return on capital and figure out a way to unlock that value through restructuring management change and so if they can unlock that and get to a higher return on capital business and they can do that, buy right sell it right and do it over and over again while we're buying businesses that if we can find these high returns on capital with the sustainability we can own them for a long time with low turnover. I think part of the reason why people kind of think of us as growthier than your value manager is that Russell, Morningstar, a lot of these entities, organizations want to put stocks in two buckets, either in value or in growth. One of the main things they use in that decision point is price to book. I think price to book today is less meaningful across all of the sectors. Maybe it's still meaningful in the banking and financial sector today in terms of valuation but when you think about businesses today its much more of a service economy rather than an industrial economy. In a service economy you have less fixed assets and so therefore, the main assets that most companies have is their people and so it's not reflected in the book and so therefore, companies typically have higher book value today because of the service economy. The other thing too I would say that if you think about price to book in relationship to ROE, a company with a 10 percent ROE versus another company with a 20 percent ROE, just by that definition, the price to book with a 20 percent ROE company will be higher. and so therefore, we're investing in the high returns on capital businesses the higher ROE businesses and so therefore, they just have a natural tendency to have a higher price to book. That doesn't speak to how cheap or expensive they are relative to the other companies but Morningstar and Russell uses a very hard definition of price to book is determination of value and growth and so we disagree with that and that's why we've always been having to explain this over and over again.

Jordan: That's very helpful, Craig and two other questions. One of them is this is more macro related but it's definitely a theme that's been coming along recently. It's related to tax reform. Can you talk about it? Both the impact on the portfolio and in general the impacts on small-caps across the board.

Craig: I think, Jordan the easy answer is obviously tax reform has been a bigger beneficiary to small-caps simply because they have had a higher tax rate to begin with. So on an average, prior to the tax reform, if you look at most small-caps and when we looked at our portfolios in particular, on average our companies are paying about a 31 to 32 percent tax rate while most global businesses, large-cap, mega-caps were paying about a 25 to 26 percent average rate. So when the tax reform happened and the corporate tax across the board came down to the 21 percent level, small-caps got a bigger benefit from that drop than most large-caps and mega-caps so therefore, the earnings growth and earnings power of small-caps are going to be greater due to the tax reform.

Jordan: Thank you. Last question is there's been a lot of talk around the industry related to the potential momentum shift moving from a growth bend to a value bend. My question is what are your views on this and how does this impact your portfolio and thoughts in general?

Craig: The growth and value cycles have occurred often in the past. You can trace them all the way back to 2000/2001 where growth fell out of favor and value got back in favor. But if you look prior to that, in 1998/99 where growth was in favor and value was out of favor, you saw a lot of value managers go out of business or close their doors, but three years later if they had stayed in business it would have been the time to invest in them. So I think value and growth will always come and go. There will always be cycles between them. Over time we think that there shouldn't be too much disparity between growth and value. So currently we're in a growth cycle and everyone wants to invest in growth and not value but there's going to come a time where everyone's going to want to invest in value and not invest in growth. We think it's always proven to allocate money to where investors are not heading or investors are not chasing. We think that it's better to always allocate to the style or the sector that is underperforming the most knowing that over the long periods of time everything will come back to a more normal or equilibrium.

Craig: As for the portfolio we don't let these kind of things dictate how we invest or what we invest in we try to let valuation dictate where we should be in terms of overweight or underweight sectors and so therefore, certainly, if you look at the more value style sectors, financial being one of them, we probably have a higher weight in financial sector than we've had in a long time simply because that's where we're finding the most opportunistic valuation opportunities and so while it doesn't affect how we think about businesses in terms of quality, valuation and certain periods and sectors can lead us to underweight or overweight certain sectors.

Jordan: Thank you very much for your time. These are great answers to provide additional color on the portfolio, characteristics of all as well as a little bit of a macro overview so thank you as always for your time and we look forward to future conversations, Craig.

Craig: Thank you, Jordan.