KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 65

Third Quarter 2018 Review of the Small-Cap Quality Value Portfolio

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Jordan: Today we will be reviewing the Kayne Anderson Rudnick Small-Cap Value portfolio. With me I have Julie Kutasov, Senior Portfolio manager with the strategy. Julie, first off thanks for setting aside the time today. Can we start by reviewing the performance of the Russell 2000 Value index for the third quarter along with performance of the KAR Small-Cap Value strategy?

Julie: Sure. U.S. stock market returns were once again solid in the third quarter as strong economic growth and better-than-expected earnings continued to overwhelm concerns about trade wars and Federal Reserve policy. Larger cap stocks outperformed smaller cap names with the S&P 500 rising 7.7% versus 3.6% for the Russell 2000 Index. Growth stocks outpaced value names. The Russell 2000 Value Index, our benchmark, was up 1.6% in the third quarter with strong returns in sectors such as healthcare (which was up over 7%), utilities (which was up nearly 6%), and producer durables (up over 5%) offsetting weakness in consumer staples, energy, and financial services.

As expected the year's third fed funds rate increase was announced following the Fed's meeting in September with another one anticipated in December this year and at least three additional increases projected for next year. One byproduct of rising rates has been under-performance of interest rate-sensitive segments such as real estate and banking. Real Estate Investment Trusts represent an over 13% weight in the Russell 2000 Value Index and were nearly flat in the third quarter. And banks represent a roughly 17% weight in the benchmark and were down 1.5% during the quarter.

The Small-Cap Quality Value Portfolio outperformed the Russell 2000 Value Index by over 300 basis points during the third quarter primarily due to strong stock selection in the financial services and consumer staples sectors. In financials our strong performance was helped by an underweight exposure to the capital intensive REIT and banking segments which, as I mentioned, combined represent nearly a third of the Russell 2000 Value benchmark. Our top stock contributors were two financial names: Jack Henry & Associates (ticker JKHY) and Primerica (ticker PRI).

Jack Henry is a leading provider of computer systems and transaction processing services to financial institutions. Technology has leveled the playing field between larger and smaller financial institutions supporting robust demand for top notch solutions from Jack Henry's core customer base of community banks and credit unions. Importantly, the company's core processing system becomes highly integrated with clients' daily operations making switching to a new vendor both disruptive and costly.

Primerica is the nation's largest distributor of term life insurance and investment products to middle income households. The company reported a strong quarter driven by continued execution via increasing salesforce, investing in digital capabilities, and expanded product offerings. We continue to view Primerica's distribution scale as a key competitive advantage. It allows the company to invest in recruitment and training of salesforce, implement better technology tools, and spread ever rising administrative and regulatory costs over a broader revenue base.

As I mentioned, we also had strong stock selection in the consumer staples sector. The benchmark sector posted a negative 5.2% return in the third quarter while we delivered an over 12% return driven by both of our holdings: WD-40 Company (ticker WDFC) and National Beverage (ticker FIZZ).

Jordan: The firm's focus has always been on covering high-quality long-term investments. Looking back at the 3rd quarter would you say this was an environment driven by high or low quality stocks?

Julie: There was a "mixed" element to the quarter. On one hand, Russell 2000 Value companies with lower S&P stock rankings and higher beta did better. On the other hand, names with higher returns on equity outperformed those with lower ROEs. Benchmark names with ROE over 15% were up roughly 4% during the quarter. Note that nearly two thirds of our portfolio is in names with ROE over 15% versus less than 13% of the Index. More importantly, nearly two thirds of our portfolio boasts under leveraged or debt-free balance sheets as higher ROEs can be achieved through greater financial leverage.

Jordan: Thanks for that response, Julie. And let's take a deeper dive into some of the key attributors to the portfolio. Can you walk us through first some of the key drivers during the third quarter and also some of the key detractors during the quarter and provide us with some color on some of those names?

Julie: Sure. As I mentioned the sector that contributed the most to our performance was financial services with strong performance by Jack Henry and Primerica and our lower exposure to the REIT and banking segments. Our third highest individual stock contributor was a materials sector holding - RBC Bearings (ticker ROLL) which is a leading provider of highly engineered precision bearings and components to the aerospace & defense and general industrial markets. RBC's products are engineered into their customer's end products making them difficult to displace and creating a natural after-market for replacement parts. The stock continued to perform strongly driven by solid operating results with impressive top line growth (supported by robust industrial demand) and margin expansion.

The sector that detracted the most from our performance was consumer discretionary driven primarily by under-performance by SiteOne Landscape Supply (ticker SITE) and Thor Industries (ticker THO).
Let me discuss SiteOne first. Added to the portfolio early last year, the stock continues to be one of our highest contributors both year-to-date and for the trailing five year period. SiteOne is the largest and only national wholesale distributor of landscape supplies. Its customers are landscape contractors who service both residential and commercial accounts. SiteOne is connecting two fragmented markets: Those of landscape contractors and product manufacturers leveraging its size to exert pricing pressure on suppliers while at the same time commanding premium pricing versus local competition.

Shares declined in September following reports of greater than expected materials' and freight costs' inflation yet to be mitigated by recently implemented by the company price increases. Our investment thesis remains intact, however. Despite being the largest player SiteOne holds just a 10 percent share of its highly fragmented wholesale landscape supply market which the company continues to consolidate allowing plentiful opportunity for sustainable top line growth and profitability expansion.

Thor Industries is the largest manufacturer of recreational vehicles (or RVs) in the U.S. Shares suffered due to investor concerns of a top in the RV demand cycle and a potential for an inventory glut. While these are valid concerns for a cyclical industry, we believe that Thor, along with other RV manufacturers, should continue to benefit from younger buyers entering the RV market primarily with purchases of entry-level tow-able units. These first-time buyers should also represent an opportunity for future sales as they get older and upgrade to more comfortable higher-end vehicles.

Jordan: Julie, the last question revolves around valuations. There have been many discussions related to valuations in a market that's gone up for 10 years, where are you seeing opportunities to put new money to work and can you please walk us through an example of one of these companies.

Julie: As long-term investors in highest quality companies we like to think of ourselves more so as investors in businesses rather than investors in stocks. With our low (roughly 25 percent) turnover and focused portfolios of 25 to 35 names (29 currently) we have the luxury of being both nimble and patient as we search for pockets of opportunity. This opportunity may come in a form of a company in the industry under pressure that is better protected from those pressures. Such was our investment in Core Labs (ticker CLB) in the midst of the energy downturn back in 2015. Core Labs is a leading provider of reservoir description, production enhancement, and reservoir management services to the oil and gas industry. While the company cannot be immune to commodity pricing pressures, it has been much better protected as a "go to" innovation leader with a comprehensive portfolio of value-added products helping customers enhance project economics through improved recovery. While we remain bottom-up investors we are also always searching for themes that we can identify as sustainable secular tailwinds, and where we have the ability to buy at fair to attractive valuations. An example of such approach is our recent investment in Brooks Automation (ticker BRKS) in the technology sector.

Brooks Automation provides automation and cryogenic solutions for multiple markets including semiconductor capital equipment and life science biological sample management and storage where it serves pharmaceutical and biotechnology companies, bio-banks, and research institutes. As such Brooks represented an interesting opportunity to gain exposure to a fast-growing life sciences sample storage market which is fueled by growth in direct-to-consumer testing, regenerative medicine, biotech development, and personalized medicine. Interestingly, once generated a sample rarely gets disposed of due to its potential to be helpful years later for perhaps unrelated research. Centralized sample storage with clear attribute labeling can help expedite the entire research process. Brooks offers the most comprehensive solution for sample storage that combines the company's expertise in both cold storage and automation. It has made substantial investments to develop cutting edge facilities that protect and automate the chain of custody for a sample solutions that have proven to be very compelling to customers including some of the largest pharmaceutical companies and academic institutions.
In both its life sciences and semiconductor equipment businesses, Brooks benefits from high switching costs. In life sciences, most customers are keen to maintain impeccable chain of custody for samples. This includes not just

cold storage but automation and documentation surrounding the samples. Any disturbance to a large sample set in the transport or handling would be very problematic. In general, once you've outsourced your sample storage to a provider, you are very unlikely to move it anywhere else. And on the capital equipment side, two thirds of Brooks' products are "designed in" directly to the OEM customer with long sales cycles.

In a relatively short period of time, Brooks has been able to transfer its leadership in the semiconductor capital equipment space to the life sciences industry. It has done so by offering differentiated technology and establishing a reputation for outstanding service delivery. This "know how" has been supplemented with acquisitions of medical technology companies to create a comprehensive offering that is unparalleled in the industry. As the life sciences business continues to grow, the segment should experience material economies of scale and consequent profitability expansion. Management is also targeting continued gross margin improvement in the semiconductor business driven by higher-growth, higher-margin products.

Jordan: Julie, thank you again for your time and input. We look forward to future discussions. Thank you.

Julie: Thanks, Jordan. My pleasure.