KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 66

Third Quarter 2018 Review of the Small-Mid Cap Core Portfolio

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Jordan: Today we're going to review the Kayne Anderson Rudnick Small-Mid Cap Core strategy. With me I have Senior Portfolio Manager, Julie Kutasov. Julie, thank you for taking the time and can you start by giving us a review of the Russell 2500 index along with performance of the Small-Mid Cap Core strategy.

Julie: Sure. U.S. stock market returns were once again solid in the third quarter. Strong economic growth and better-than-expected earnings continued to overwhelm concerns about trade wars and future Federal Reserve policy. The Russell 2500 Index, our benchmark, was up 4.7 percent with strong returns in sectors such as technology (which was up over 11 percent for the quarter) and healthcare (which was up 10 percent) more than offsetting weakness in consumer staples (which was the only sector with a negative return in the quarter), energy, and financial services.

The Small-Mid Cap Core Portfolio outperformed the Russell 2500 Index by roughly 100 bps during the quarter primarily due to strong stock selection in the financial services and materials sectors.

In financial services Primerica (ticker PRI) was our top contributor. 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 strong competitive advantage. It allows the company to invest in recruitment and training of salespeople, implement better technology tools, and spread ever rising administrative and regulatory costs over a broader revenue base.

Our strong performance in financials was also helped by lack of exposure to the under-performing real estate investment trust or (REIT) segment which represents a nearly 10 percent weight in the Russell 2500 Index. With another Fed funds rate increase announced following the Fed's meeting in September and with at least three additional increases projected for next year, real estate names suffered. We have no REITs at this time, and this underweight is structural in nature due to REITs' inherent capital intensity and low competitive differentiation.

As I mentioned we also had strong stock selection in the materials sector. The sector lagged the overall benchmark's performance in the third quarter while we delivered a nearly 9% return driven by RBC Bearings (ticker ROLL) which is a leading provider of highly engineered precision bearings and components to 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, better-than-expected operating results with impressive top line growth (supported by robust industrial demand) and margin expansion. In general the nature of our exposures in the materials segment will always be very different from the benchmark as we shy away from both commodity exposures and capital intensity.

Jordan: Kayne's focus has always been on investing in high "quality" investments. Can you walk us through if the third quarter was driven by high or low quality stocks?

Julie: There was a "mixed" element to the quarter but overall I would describe it as more of a lower quality one. Companies with lower S&P stock rankings, higher beta, higher price-to-earnings ratios, higher financial leverage did better. On the other hand benchmark names with return on equity over 20 percent were up nearly 7 percent. Note that nearly 60 percent of our portfolio is in names with ROE over 20 percent versus 22 percent of the Index. More importantly, over 50 percent of our portfolio boasts low debt or debt-free balance sheets as higher ROEs can certainly be achieved through higher financial leverage.

Jordan: To take a deeper dive into this SMID strategy can you let us know what some of the key attributors to the portfolio have been not only for the quarter but year to date, as well as some of the key detractors for the portfolio both for the third quarter as well as year to date?

Julie: As I mentioned the sectors that contributed the most to our performance were financial services with names such as Primerica and materials with strong performance by RBC Bearings. Our highest performer, however, was a technology name-Aspen Technologies (ticker AZPN). The company is also one of our highest contributors for the trailing five year period.

Aspen Technology provides mission-critical process optimization software used in plant management, process design, and supply chain planning. Aspen represents one of the more protected businesses in application software, in our view. Customers rely on Aspen's software to run daily operations and drive efficiency improvements. The company's ability to grow its total contract value through the last recession demonstrates how central the software is to running customers' day-to-day operations. Aspen continues to generate healthy results, and is currently seeing some renewed interest from engineering and construction clients, the segment that has been struggling from the decline in oil prices.

The sector that detracted the most from our performance was consumer discretionary driven primarily by under-performance by Wynn Resorts (ticker WYNN). Wynn develops and operates destination casino resorts both in the U.S. and Macau. In fact, Wynn is one of only few gaming companies with a license to operate in Macau where it generates nearly three quarters of its total revenues. Investors have grown increasingly concerned about aggressive price competition for VIP players in Macau in the form of increased commissions to junket operators and additional credit extended to players. Wynn management made it clear that they will not compete on price. The company continues to be optimistic on longer-term industry trends in Macau and its ability to grow market share there.

Jordan: There have been many discussions focused on valuations in a market that's gone up for ten years. Can you walk us through where you are seeing some opportunities to put new money to work and can you also let us know an example of one of these companies?

Julie: Sure. As long-term investors in highest quality companies we like to think of ourselves more as investors in businesses rather than investors in stocks. With our low (roughly 25 percent) turnover and focused portfolios of 25-35 names (28 currently) we have the luxury of being both nimble and patient as we search for pockets of opportunity. Such opportunity may come in the form of a company in the industry under pressure that is well insulated from those pressures. Such was our initial investment in Aspen Technologies back in 2015 when some of their customers were suffering from low oil prices but deeply embedded mission-critical nature of the company's product allowed for stability. While we remain bottom-up investors we are 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 may be our recent investment in Charles River Laboratories (ticker CRL) in the healthcare sector. Charles River is a contract research company that provides drug discovery, non-clinical development, and safety testing services worldwide. The company serves pharmaceutical, biotechnology, agricultural, veterinary medicine, and medical device companies, hospitals, academic institutions, and government agencies.

This is a company we have monitored for several years and spoken to management on several occasions. Our biggest hurdles were the company's M&A strategy as well as the uneasiness related to biotech funding. While these issues have not gone away, we believe the company has nicely diversified itself as an end-to-end provider of services from early stage all the way through drug approval. While we are not fond of acquisitions overall we do believe there are firms that can conduct an effective M&A plan over time. Charles River's M&A track record is a solid one. They have been able to accomplish this by focusing on companies which are too small to "move the needle" for their larger size peers.

The early stage emphasis is the key reason that we like the business, however. More drugs are coming through the pipeline, and Charles River is helping these products come to market faster saving customers lots of money. Due to the comprehensiveness of their services, Charles River can tailor solutions to customers' needs. This is especially vital for young biotechs that need to outsource more given their need for internal investments and focus. The company's strong market positioning also allows it to maintain solid pricing power. As a result Charles River has been a consistent top and bottom line grower while seeing free cash flow increase over time.

Jordan: Julie, thank you again for setting aside the time. We look forward to hearing from you in the future.