KayneCast

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Episode 68

Third Quarter 2018 Review of the Global Dividend Yield Portfolio

Richard Sherry, CFA
Senior Portfolio Manager & Senior Research Analyst

Jordan: Today we're going to hear from Richard Sherry, Senior Portfolio Manager of the Kayne Anderson Rudnick Global Dividend Yield portfolio. Rich, thanks for taking the time. Can you start by providing us with an overview of the portfolio and the investment focus of this Global Dividend Yield strategy?

Richard: Yes, the Kayne Anderson Rudnick Global Dividend Yield portfolio is designed to provide investors with a high level of current income while minimizing risk and preserving capital. With interest rates being as low as they have been, many investors have looked to the equity markets as a place where they can find extra yield. However, high dividend yields in the equity markets often come with risk. Many high yielding stocks represent either unsustainable or volatile dividends or an investment in a cyclical business. Unfortunately, the typical way to reduce that risk is to invest in only the safest dividend stocks, which generally offer only a pedestrian yield. Our portfolio aims to allow investors to achieve a strong yield without taking on undue risk. We achieve that by focusing on only the high quality part of the high yielding equity universe. Within that universe we focus only on the businesses that have sustainable competitive advantages, strong balance sheets, produce solid cash flow and can maintain a dividend in good times and bad. In addition, our approach does not limit us to certain sectors or geographies. This diversification has also contributed to the portfolio achieving a strong yield while also having a lower risk profile.

Jordan: Rich, thank you for the overview. Can you now walk us through the third quarter and discuss the portfolio's performance vs. the Russell Developed Large-Cap Index?

Richard: The portfolio under-performed the Russell Large-Cap Developed Index, which produced a mid-single digit return during the quarter. The quarter had a strong start as companies reported solid results across the board, with most companies articulating a generally positive outlook for the rest of the year. During this period we had strong performance which was in line with the benchmark. In August, interest rates began to rise. This followed a several month period where interest rates had been in range. This move higher in interest rates contributed to an under-performance among the interest rate sensitive stocks in our portfolio during the month of August.

However, in September, as rates continued to rise, equity markets began to get nervous about several things, which created an environment where our portfolio out-performed. Among other things, markets have become concerned about the negative implication of higher interest rates on businesses and stock valuations, a US-China trade war, weakness in emerging markets, Brexit, higher input costs for businesses and a potential slowdown in demand.

When the market gets nervous about these kinds of things, investors tend to seek comfort in the kinds of stocks that are in our portfolio. These stocks represent businesses that are more resilient to economic downturns and provide investors the comfort of a nice dividend.

Jordan: Kayne's focus is on investing in high quality, high yielding equity securities. How did these securities do in the third quarter?

Richard: High quality stocks overall did very well during the quarter, but that out-performance was led by the lower yielding subset of those stocks, notably in the technology and healthcare sectors. However, the high quality, high yielding stocks that we own did quite well. They didn't go up at quite the mid-single digit rate of the benchmark, but they did appreciate nicely during the quarter. They started the quarter strong and went up in line with the benchmark, they gave up a little bit when rates began to rise in August and then they outperformed in September when the benchmark appreciated only modestly. That out-performance has continued into early October as markets remain concerned about the issues noted earlier.

Jordan: Let's look at some individual names within the strategy. Will you walk us through an example of a key attributer during the quarter as well as a key detractor during the third quarter of 2018?

Richard: As has been the case for a couple of years now, technology stocks were strong and produced a low double digit return for the quarter. That strong performance was led by low or no yielding technology stocks. Unlike other industries, such as utilities and telecom, a very high yielding technology stock is usually not a good investment. That being said, there are some technology companies that I've differentiated and generate strong cash flow that fund steady dividends. We do invest in those, but there are just not as many of them as there are in other sectors. As a result we are typically underweight the technology sector and in periods of strong performance among technology stocks, that tends to result in a negative drag on our relative performance as it did this quarter.

In terms of geographic exposure, we had two stocks in the portfolio, Las Vegas Sands and HSBC, that were negatively impacted by their exposure to China. Concerns about a US-China trade war and a slowdown in China have weighed on stocks with Chinese exposure and these two were no exception. They were both weak during the quarter.

An area that has been weak recently but did perform better in the quarter is tobacco stocks. These stocks, which have always provided nice steady dividends, have been under pressure recently due to concerns about the transition to next generation products and competition from new entrants. Juul, an upstart entry in the space, is just now beginning to receive increased attention from the FDA due to its success among teenagers. This bodes well for the established players in the industry.

Our real estate stocks had a really strong quarter. Lamar, a billboard company based in the US, saw a nice pickup in business activity, especially among digital billboards. And Crown Castle continues to see its cell phone tower

business produce strong results. In addition, Scor, a Paris based global reinsurer received a takeover offer from a French rival during the quarter. The company rejected the offer, but the stock was strong on the back of that offer. Finally, a couple of our pharmaceutical investments, Merck and Astrazeneca, had solid performance during the quarter driven by strong results in their oncology businesses.

Jordan: Rich, the last question I have for you is when we look at rates and where they are with a portfolio that's focused on generating income, can you walk us through, both domestically and globally, where you're finding the most opportunities for future investments? Thank you so much.

Richard: First, as on overview we have several different types of businesses that we generally find attractive. One of those is slower growing mature businesses that generate excess capital and have management teams that return that excess capital to shareholders via dividends. These businesses tend to have a "sticky" revenue base that generally carries over from year to year and is less exposed to economic volatility. Think utilities, trash collection and food service for hospitals and universities. We do also invest in cyclical businesses that have certain characteristics such as strong balance sheets and a resiliency in their cash flows that allow them to maintain dividends, even during tough times. These stocks tend to be in sectors such as energy and industrials. However, we will generally be under-weight those kind of stocks.

Earlier this year the market became quite pessimistic about consumer staples stocks due to concerns about valuation and increased levels of competition from upstart competitors. We used that weakness to make investments in companies that we felt were more immune to those pressures and had historically not provided a good enough yield to get us interested. That resulted in investments in Clorox and Coca-Cola. When the market presents opportunities like that, we take advantage of them, and we are always on the lookout for situations like that.

Today we are most excited about finding new investment opportunities in those slow growing, mature businesses that pay really nice dividends. This would be a company that has a strong competitive position, operates in a slow growing, mature market, has a solid management team and generates enough excess capital that when it returns that capital to shareholders in the form of dividends, shareholders receive a very attractive dividend yield somewhere in the range of 4 to 6%. We look for those businesses all around the globe. Sometimes they represent businesses whereby geography protects them from competition, but also limits their re-investment opportunities, which results in lots of excess capital that is returned to shareholders via dividends. Places like Hawaii, Canada and New Zealand. Sometimes it represents a business such as food service or waste collection or billboards that represents a dominant national or international position, but could be headquartered in Louisiana or London or Sydney. Sometimes it represents strong global franchises in industries such as pharmaceuticals or insurance.

There exist many such opportunities around the world and it is these kinds of steady businesses that pay nice dividends where we are finding the most interesting investment opportunities today. It is investments in these kinds of businesses whose stocks have high dividend yields that will allow the portfolio to continue to produce a yield that is superior to what can be found in the fixed income market.

Jordan: Rich, thank you again for your time and we look forward to speaking to you in future quarters. Have a great day.

Richard: Thanks, Jordan.