Episode 70

Fourth Quarter 2018 Review of the Small Cap Core Portfolio

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Jordan: Hello, this is Jordan Greenhouse, Client Portfolio Manager with Kayne Anderson Rudnick. Along with me today I have Senior Portfolio Manager of the Small Cap Core portfolio, Jon Christensen. Jon, first and foremost, thanks for setting aside the time today. What I would like to start with today is a review of the fourth quarter, 2018. We noticed a substantial uptick in overall equity market volatility Can you provide us with performance information of the portfolio for the quarter as well as year-to-date for the Small Cap Core strategy?

Jon: Of course. We obviously saw a substantial decline in the market in Q4 with the Russell 2000® Index falling over 20% in the quarter – with 2018 overall falling 11% for the Index. So a tough year for equities overall. As we usually position ourselves, we expect to outperform in these types of markets given the high-quality bias we have in place for our portfolios. This was indeed the case for the quarter and for the year. In Q4 for example, we outperformed the market by over 500 basis points driven by superior stock selection in technology and producer durables leading the way. When looking at the overall market in the quarter, lower-quality stocks were down more than higher quality stocks in several measures including S&P® stock ranking, beta, and debt on the balance sheet. For 2018 it was basically the same story, as our portfolios outperformed by about 1,000 basis points with stock selection – surprise – being the main driver making up about 90% of the outperformance for the year overall as the market again was characterized by more lower quality businesses in general.

Jordan: What were some of the key attributors to the portfolio during the quarter and can you walk us through an example or two?

Jon: So the biggest contributor in terms of stocks to the portfolio this quarter was MarketAxess. MarketAxess operates the leading electronic trading platform for U.S. corporate bonds. The platform has the largest network of both buyers and sellers, providing trading participants the most liquidity and the best price for fixed income transactions. The stock appreciated after the company reported, in its most recent quarter, significant share gains in the U.S. high-yield bond, emerging market, and Eurobond markets driven by its all-to-all trading protocol, Open Trading. The business should continue to be a secular share-gainer because of the cost efficiencies provided by the network's growing liquidity pool, and we remain owners.

Jordan: Additionally Jon, if possible, can you walk us through an example of one of the detractors during the quarter that impacted the portfolio?

Jon: Sure. The biggest detractor from performance this quarter was Aspen Technology. Aspen Technology engages in the provision of mission-critical process optimization software solutions designed to manage and optimize plant and process design, operational performance, and supply chain planning. After outperforming for much of the year, shares in Aspen corrected in line with the other software technology stocks. Financial results this year have been negatively impacted by accounting changes from 606, which makes year-over-year comparisons more challenging. That said, demand remains strong for the core platform as well as the asset performance maintenance suite of products. Free cash flow continues to be strong and with management repurchasing shares regularly, we also remain shareholders.

Jordan: Jon, as referenced before, related to the market volatility we saw during the fourth quarter, can you let us know if this has provided you and your team with any opportunities to add new investments to the strategy over the last few quarters and can you provide us with an example of one of those names and the rationale behind?

Jon: Sure. While we did not have any new investments enter the portfolio in the fourth quarter, we have made some increases in certain names as the market has trended lower. In previous quarters we have bought lighter than normal positions in new businesses given valuation concerns. These lower weights have allowed us flexibility to add to those as shares as they have weakened. This is a common theme for us as once we have a solid investment idea; the weight size is usually dictated by valuation as well as future outlook.

Jordan: Last question I have for you, Jon, is we are approaching ten years into this bull market. When looking at your portfolio and Kayne Anderson Rudnick's overall approach, are there any factors that you and the team are more focused on moving forward?

Jon: Yeah. Our focus over the long-term is the same, whether we are in a recession or long in the tooth of a bull market: find great, high-quality businesses that we believe will grow and prosper over the long-term while maintaining a competitive advantage over its peers and investors rewarding them for that. This mandate is stagnant and consistent. Thanks Jordan.