Episode 71

Fourth Quarter 2018 Review of the Mid Cap Core Portfolio

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Jordan: Hello this is Jordan Greenhouse, Client Portfolio Manager with Kayne Anderson Rudnick. Along with me, I have Jon Christensen, Senior Portfolio Manager of the Kayne Anderson Rudnick Mid Cap Core portfolio. Jon, first off thank you for setting aside the time to review this with us and what I'd like to start with is a look back at the fourth quarter of 2018. During the quarter we saw a substantial uptick in overall volatility within the equity marketplace. Can you provide us with some performance information for the portfolio for the quarter, as well as year-to-date performance of the Mid-Cap Core strategy?

Jon: Absolutely. We saw a substantial decline in the market in Q4 with the Russell Mid Cap® Index, falling over 15% in the quarter – with 2018 overall falling 9% for the Index. So a tough year for equities. 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, we outperformed the market by about 180 basis points, as superior stock selection in healthcare and producer durables led the way. When looking at the overall market in the quarter, lower-quality stocks were down more than higher quality stocks in several different measures, including S&P® Stock ranking, beta, and debt on the balance sheet. For the 2018 year it was basically the same story as our portfolios outperformed by about 600 basis points with stock selection being the main driver – making up about 90% of the outperformance for the year, as the overall market, again was characterized by more lower quality stocks driving the market.

Jordan: Jon, what were some of the key attributors to the portfolio and can you walk us through one or two examples that affected the portfolio during the fourth quarter?

Jon: Yeah. The biggest contributor in terms of stocks to the portfolio this quarter was Lamb Weston. Lamb Weston is the second largest producer of frozen potatoes in the world (#1 in the U.S.). In October, the company reported solid revenue growth compared to the previous year. Global frozen potato supply remains tight because of crop disruptions in Europe, and Lamb Weston continues to create new demand by growing its retail offerings. Lamb Weston continues to benefit from scale advantages, strong global demand for frozen potatoes and rational competition among the three global players, who combined, have vast majority of the market. As a result we remain owners of the overall business.

Jordan: Thanks for that response. Jon, can you also walk us through an example of a detractor during the quarter for the portfolio and some of the key drivers for that?

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 the accounting changes from 606, which makes year-over-year comparisons more challenging. That being 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 with management repurchasing shares regularly. We remain shareholders of the business.

Jordan: Jon, has the recent market volatility provided you with any opportunities to add new investments to the strategy over the last quarter or even last couple quarters? If possible, can you provide us an example of a name that you've recently added to the portfolio and the rationale as to why?

Jon: Absolutely. The market weakness did present us with some opportunities to not only add to existing businesses but also to add new business as well. We initiated a position in Brooks Automation as the market fell. Brooks engages in the provision of automation and cryogenic solutions for multiple markets, including semiconductor capital equipment and life science biological sample management and storage. 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 the actual 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 for these customers. In general, once you've outsourced your sample storage to a provider, you are very unlikely to move it to a new provider. On the capital equipment side, two thirds of Brooks' products are designed-in directly to the OEM customer with long sales cycles. So this is a company that is evolving from a more semi capital equipment company to a life sciences company. This transition should take time, but we believe the revenue and margin profile should improve as they go forward.

Jordan: Jon, the last question I have and thank you in advance for your time today. We are approaching ten years into this bull market cycle. When looking at the portfolio and Kayne's overall approach on quality, are there any factors that you and your team are most focused on moving forward?

Jon: Sure. 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. Thank you Jordan.