KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 72

Fourth Quarter 2018 Review of the Small Cap Quality Value Portfolio

Julie Kutasov, CFA
Portfolio Manager & Senior Research Analyst

Jordan: Hello this is Jordan Greenhouse, Client Portfolio Manager with Kayne Anderson Rudnick. Along with me today I have Julie Kutasov, Senior Portfolio Manager with the Kayne Anderson Rudnick Small Cap Quality Value strategy. Julie, first and foremost, thanks for setting aside the time today to review the Small Cap Quality Value strategy with us for 2018. During the 4th quarter of 2018, we noticed a substantial uptick in overall market volatility on the equity side. Can you provide us with performance for the portfolio during the quarter, as well as year-to-date numbers?

Julie: Hi Jordan. Sure, U.S. stock market declined amid increased volatility during the fourth quarter. Investors were concerned about global economic slowdown, trade wars (particularly the trade conflict with China), domestic housing market deceleration, and interest rate policy. Smaller caps were hit the hardest – the Russell 2000® Index was down 20% for the quarter and 11% for the year while the S&P 500® Index was down 13.5% in the fourth quarter and 4.4% for the year.

Short-term interest rates continued to rise with the year's fourth Fed funds rate increase announced following the Federal Reserve's meeting in December and two additional increases expected this year. The 10-year Treasury yield increased only slightly in 2018, despite the four rate hikes, and dropped sharply during the fourth quarter, ending the year at 2.7%.

The Russell 2000® Value Index, the strategy's benchmark, declined 18.7% in the fourth quarter bringing the full year return to a negative 12.9%. Every single sector of the Index posted a negative return during the quarter with the worst performing being energy (down over 40%), healthcare (down nearly 30%), and materials (down 28%) and with the best performance by the utilities sector (which was down 5%). In fact, utilities were the only sector in the Russell 2000® Value Index with a positive return for the full year while the energy, materials, and consumer staples sectors performed the worst.

Investor "flight to safety" led to outperformance by higher quality names (in terms of higher earnings and balance sheet quality and lower beta) both during the fourth quarter and for the year. This is a favorable environment for us as investors in highest quality companies.

One byproduct of this investor "flight to safety", however, was outperformance by so called "bond proxy" segments such as Real Estate Investment Trusts (or REITs) and utilities both for the quarter and the year. The two segments represent a sizable portion of the Russell 2000® Value Index – REITs are a nearly 14% weight, and utilities a roughly

8% weight. We have a structural underweight in both REITs and utilities. Currently we have no utility holdings, and our only REIT position is MGM Growth Properties (ticker MGP). The reason? Inherent capital intensity, low competitive differentiation, and in the case of regulated utilities, also capped returns. This underweight position hurt our relative performance both for the quarter and for the year.

The Small Cap Quality Value portfolio outperformed the Russell 2000® Value Index slightly during the fourth quarter driven by favorable stock selection in the materials and producer durables sectors. We also benefited from a lower exposure to the underperforming energy sector. Our higher exposure to the underperforming materials sector and the lack of exposure to the outperforming utilities sector detracted from our performance, however.

For the full year the portfolio lagged the Russell 2000® Value Index by roughly 200 basis points with favorable stock selection in the consumer staples, materials, financial services, and producer durables sectors and the benefit from a lower exposure to the underperforming energy sector more than offset by unfavorable stock selection in the consumer discretionary and healthcare sectors as well as a drag from a higher exposure to the underperforming materials and consumer staples sectors and (again) the lack of exposure to the utilities sector.

Jordan: What were some of the key attributors to the strategy and can you walk us through an example of what were some of the key drivers that made that stock perform?

Julie: Sure. The two sectors that contributed the most to our performance during the quarter were producer durables and materials. Both sectors are highly capital-intensive and cyclical by nature but it is in this challenging type of an environment where our differentiated investment approach of focusing on most protected capital-light business models shines through.

In terms of our top stock contributor, it was WD-40 Company (ticker WDFC), a consumer staples name. I am pretty sure that all of you are familiar with the company's multi-purpose lubricant products. The company has a strong brand (one of the most recognizable in the U.S.) that they are successfully leveraging in new products. It also provides the company with solid pricing power that helps offset any input cost inflation. And the segment that detracted the most from our performance during the quarter was utilities- as I discussed – due to our lack of exposure to the strongest-performing sector.

Jordan: Julie, on the flip side can you walk us through an example of a portfolio detractor during either the quarter or during the year for 2018?

Julie: Sure. The weakest name for us during the quarter was Core Labs (ticker CLB)-our only energy holding. Core is one of the world's leading providers of reservoir description, production enhancement and reservoir management services to the oil and gas industry. The energy sector declined sharply during the fourth quarter driven by a dramatic crude oil price decline, and shares of Core Labs suffered alongside energy peers.

We entered the stock in the midst of the energy downturn back in March of 2015. We did realize that Core Labs could not be immune to commodity prices but expected the company to be better protected in a challenging oil price environment as the "go to" innovation leader helping customers enhance project economics through improved recovery.

Importantly, despite these challenging operating conditions, Core Labs' balance sheet remains solid, and the company continues to generate a healthy free cash flow stream, returning excess cash to shareholders in the form of cash dividends and share repurchases. Our long-term investment thesis tied to the company's differentiated capital-light business model and unique market positioning remains intact.

Jordan: Has the recent market volatility provided you and your team with any opportunities to add to new investments within the portfolio over either the fourth quarter or the last few quarters? Can you provide us with some insight as to what makes that stock a Kayne position and the rationale behind that?

Julie: We are constantly looking for new ideas but with our low (roughly 25%) turnover and a focused portfolio (28 names currently) we have the luxury of being both nimble and patient. So we are proceeding cautiously in these volatile market conditions. Although we did not initiate any new positions during the quarter we did add to a number of existing holdings taking advantage of market weakness.

One such increase in the fourth quarter was to our position in SiteOne Landscape Supply (ticker SITE). 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 adds value by connecting two fragmented markets (those of landscape contractors and product manufacturers) which allows the company to leverage its size to exert pricing pressure on suppliers while at the same time commanding premium prices versus local competition.

Shares declined in September following reports of lower-than-expected revenue growth, due to abnormal weather conditions, and continued to lag in the fourth quarter driven by investor concerns over a slowdown in the housing segment. The stock continues to be one of our highest contributors for the trailing five-year period. Our investment thesis in the company remains intact. Despite being the largest player, SiteOne holds just a 10% share (four times the size of next competitor) of its highly fragmented market which the company continues to consolidate allowing plentiful opportunity for sustainable top line growth and profitability expansion.

Jordan: Julie, the final question is as we approach the ten-year period into this bull market cycle and we look at the overall portfolio and Kayne's approach with a focus on identifying high quality businesses, are there any factors you and the team are seeing as you move forward into 2019 and beyond?

Julie: Fourth quarter certainly looked more like a bear than a bull. On a serious note it is clear that this bull market is "long in the tooth", and a combination of rising short-term interest rates, a flattening yield curve, and slowing corporate profit growth is not a favorable one for equities. At Kayne Anderson Rudnick we like to think of ourselves more as investors in businesses rather than investors in stocks. As such, our investment focus always remains the same. We are looking for superior, differentiated, protectable business models that are commonly (albeit not always) associated with low capital intensity, always with solid free cash flow generation, self-funding ability and healthy under leveraged balance sheets, and again always with disciplined capital allocation. While economic and market cyclicality is inevitable, we believe that our uncompromising focus on highest quality businesses will serve us well over the full cycle and, more importantly, over the long-term. Thanks Jordan.