



# KayneCast

A Podcast Series by Kayne Anderson Rudnick



## Episode 73

### Fourth Quarter 2018 Review of the Small-Mid Cap Core Portfolio

Julie Kutasov, CFA

Portfolio Manager & Senior Research Analyst

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Jordan: Hello, this is Jordan Greenhouse, Client Portfolio Manager with Kayne Anderson Rudnick. Along with me today I have Julie Kutasov, Senior Portfolio Manager of the Kayne Anderson Rudnick Small-Mid Cap Core strategy. Julie, thanks for taking the time today to review the quarter with us, as well as some of the year-to-date information. Let's start with this- during the 4th quarter of 2018, we noticed a substantial uptick in overall volatility within the equity marketplace. Can you provide us with performance information on the Small-Mid Cap Core strategy for the quarter, as well as year-to-date performance?

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 2500™ Index, the strategy's benchmark, declined 18.5% in the fourth quarter, bringing the full year return to a negative 10%. Every single sector of the Index posted a negative return during the quarter with the worst performing being energy (down 40%), healthcare (down 23%), and materials (down nearly 22%) and with the best performance by the utilities sector (which was down less than 4%). In fact, utilities, along with technology, were the only two sectors in the Russell 2500™ Index with a positive return for the full year while the energy and materials 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. REITs represent a nearly 11% weight in the Russell 2500™ Index, and utilities a roughly 5% weight. We have a structural underweight



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in both REITs and utilities, and currently have no REIT or utility holdings. The reason? Inherent capital intensity, low competitive differentiation, and in the case of regulated utilities, also capped returns. This lack of exposure hurt our relative performance both during the quarter and for the year.

The Small-Mid Cap Core portfolio outperformed the Russell 2500™ Index by roughly 350 basis points during the fourth quarter and 550 basis points for the year, driven by favorable stock selection in the healthcare and materials sectors. We also benefited from a lower exposure to the underperforming energy sector. And as I mentioned, our lack of exposure to the outperforming REIT and utilities segments detracted from our performance, both during the quarter and for the year.

Jordan: Julie, What were some of the key attributors to the portfolio, either for the quarter or for the year, and can you walk us through an example or two?

Julie: Sure. As I mentioned, the two sectors that contributed the most to our performance during the quarter were healthcare and materials.

In healthcare our top contributor was AMN Healthcare Services (ticker AMN), a leading provider of healthcare workforce solutions and staffing services. The company is an established leader in the large healthcare staffing services segment –yet it still holds a modest share of this fragmented market. We believe that AMN is well positioned to benefit from the growing demand for outsourced healthcare staffing services driven by aging population, increased access to healthcare, and growing shortage of medical professionals.

In the materials sector, our top performer was Lennox International (ticker LII). Lennox is the second largest Heating, Ventilation, Air Conditioning equipment manufacturer. This scale advantage allows the company to leverage fixed costs, obtain purchase discounts, and benefit from nationwide marketing campaigns. Shares recovered from an earlier decline that was driven by severe tornado damages experienced by one of the company's largest manufacturing facilities back in July. Importantly, Lennox continues to maintain a healthy balance sheet and produce a solid free cash flow stream returning excess cash to shareholders in the form of cash dividends and sizable share repurchases.

Jordan: Julie, would it be possible to also walk us through an example of a portfolio detractor during the fourth quarter?

Julie: The two segments that detracted the most from our performance during the quarter were financial services (due to the lack of REIT exposure) and utilities, again, due to the lack of exposure as I discussed.

The lowest stock contributor during the quarter was a technology name - Aspen Technology (ticker AZPN). You may recall that the company was the highest performer last quarter. It remains one of our highest contributors for 2018 as well as for the trailing five-year period.



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As a reminder, Aspen Technology provides process optimization software used in plant management, process design, and supply chain planning. The company 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.

We made our initial investment in Aspen back in April of 2015 when some of the company's customers were suffering from low oil prices. An example of us looking for a name in an industry under pressure that is well insulated from those pressures, in Aspen's case due to the deeply embedded mission-critical nature of the company's product. Shares corrected in line with other software technology stocks during the fourth quarter. They were also impacted by a dramatic decline in crude oil prices. Importantly, demand for the company's core platform remains strong, and Aspen continues to maintain a healthy under-leveraged balance sheet and produce a solid free cash flow stream, returning excess cash to shareholders in the form of opportunistic share repurchases.

Jordan: Has the recent market volatility provided you with any opportunities to add new investments within the portfolio over the last quarter or quarters and can you provide us with an example and the rationale for purchase?

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. We did, however, both add to some of the existing holdings and initiate several new positions in the fourth quarter taking advantage of market weakness.

One such new position was in SiteOne Landscape Supply (ticker SITE).

SITE is the largest and only national wholesale distributor of landscape supplies. Its customers are landscape contractors who service both residential and commercial accounts. SITE 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. Importantly, 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 last question I have is, we are approaching ten years into this bull market. When looking at your portfolio and Kayne's overall approach on quality, are there any factors that you and the team are most focused on moving forward?



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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 cyclicalities are 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. Thank you Jordan.

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