Episode 79

First Quarter 2019 Review of the Small Cap Quality Value Portfolio

Julie Kutasov, CFA
Portfolio Manager & Senior Research Analyst

Intro: Hello, you're listening to Kaynecast, a podcast that provides commentary on the economy and financial markets every quarter by the Kayne Anderson Rudnick investment management team.

Jordan: Hello, this is Jordan Greenhouse Managing Director with Kayne Anderson Rudnick, and with me today I have Julie Kutasov, Senior Portfolio Manager of the Kayne Anderson Rudnick Small Cap Quality Value Portfolio. And today we're going to discuss the First Quarter 2019.

Julie: Hello, Jordan. Happy to be here.

Jordan: Julie, looking back at the first quarter of 2019 we saw quite a reversal in the broader markets coming out of Q4 2018. Can you walk us through performance of the strategy along with the overall index performance?

Julie: Yes, quite a reversal indeed. The strongest start to a year since 1991 driven by more economically sensitive segments, the ones that suffered the greatest sell-off last quarter. The recovery was fueled by optimism on future Federal Reserve policy, outcome of U.S.-China trade negotiations, and corporate earnings' growth despite continued slowdown in global economic activity (particularly in Europe and China). Smaller stocks slightly outperformed larger ones, and growth stocks outpaced value names. The Russell 2000 Value Index increased 11.9% driven by energy, technology, and materials sectors while consumer staples, consumer discretionary, and utilities sectors lagged.

Investor sentiment was most significantly impacted by a change in the short-term interest rate outlook. The combination of a slowing global economy and the Fed's insistence on raising rates two additional times in 2019 (following the increase in December) led to the correction in late 2018. By the end of last year the market did not expect any more fed funds rate increases but it was not until early January when Chairman Powell communicated putting rate increases on hold, igniting this stock rally.

The 10-year U.S. Treasury Yield continued to decline ending the quarter at 2.4%. More importantly, late in the quarter, the 3-month-to-10-year Treasury yield curve inverted, indicating a potential need to reduce short-term rates if the inversion persists. An inverted yield curve presents a particular challenge for banks - banks account for a sizable 16% weight in the Russell 2000 Value Index and posted a lagging 7.7% return during the quarter.

At the same time investors' search for yield in this persistently low interest rate environment led to outperformance by so-called "bond proxies" such as real estate. Real Estate Investment Trusts (or REITs) also represent a significant 14% weight in the Russell 2000 Value Index and posted an impressive 16% return for the quarter.

We have a structural underweight exposure to both banks and REITs due to these segments' inherent capital intensity and low competitive differentiation, so our lower exposure to the outperforming REIT segment was mitigated by our lower exposure to the underperforming banking segment this quarter.

The Small Cap Quality Value Portfolio underperformed the Russell 2000 Value Index by roughly 90 basis points during the first quarter with strong stock selection in the financial services and producer durables sectors more than offset by unfavorable stock selection in the consumer staples, materials, and healthcare sectors.

Jordan: Julie, when we take a deeper dive into the portfolio, can you take us through some of the key contributors during the quarter?

Julie: The sector that contributed the most to our performance was financial services. This is the largest sector both in the portfolio and the benchmark, a roughly 40% weight. As I mentioned, over 30% of the Index is in banks and REITs, and we had a lower exposure to both the outperforming REIT and the underperforming banking segments. Two financial services names were among our top contributors this quarter. HFF (ticker HF) -number one and MGM Growth Properties (ticker MGP) - our top third.

HFF is a commercial real estate broker. Last year investors were concerned about slowing economy and higher interest rates potentially dampening transaction volumes. The stock recovered strongly in the first quarter after the company reported solid operating results, and then on March 19th announced that it was being acquired by a larger peer Jones Lang LaSalle.

Our second highest contributor was Scotts Miracle-Gro (ticker SMG). Most of you are probably familiar with the company's lawn and garden products. They also have a hydroponics segment that was adversely affected last year by disruptions in the cannabis grower licensing process in California. In the first quarter the segment returned to growth giving investors increased confidence that the licensing issues had been mostly worked through. We view the franchise strength of Scotts' lawn and garden business, including its hydroponics segment, as intact. In fact, taking advantage of shares' weakness, we increased our position in the stock in the fourth quarter last year.

And the third highest contributor in Q1 was MGM Growth Properties- a REIT which was formed by MGM Resorts to hold a number of casino properties that MGM operates. At the end of last year shares declined along with the broader market sell-off but recovered strongly after the company reported solid rental income growth driven by inclusion of new properties under its master lease with MGM.

Jordan: Julie, on the flip-side what were some of the detractors you saw for the portfolio during Q1 of 2019?

Julie: The consumer staples sector detracted the most from the portfolio's performance during the quarter driven primarily by National Beverage (ticker FIZZ) and WD-40 (ticker WDFC).

National Beverage develops, manufactures and markets flavored beverages such as sparkling waters, soft drinks, energy drinks, juices, and teas. In early October last year a class action lawsuit was filed alleging that the company's sparkling water LaCroix, its largest and fastest-growing brand, contained harmful artificial ingredients. Nielsen data since then has indicated first a slowdown and then a decline in LaCroix sales after years of double-digit growth increasing concerns over a potential impact of the lawsuit on the consumer perception of the LaCroix brand as well as a general increase in competitive offerings. We continue to believe that LaCroix's position as one of the leading brands in the growing flavored sparkling water category remains intact but are closely monitoring for any developments on the competitive front.

WD-40 was our top performer last quarter and remains among top contributors for the trailing 12 months. I am pretty sure that all of you are familiar with the company's multi-purpose lubricant products. WD-40's brand is one of the most recognizable in the U.S., and the company is successfully leveraging it in new products. Importantly, the brand also provides WD-40 with solid pricing power that helps mitigate any input costs' inflation albeit price increases were not sufficient to fully offset significant raw materials' cost inflation during the most recently reported quarter. We see these issues as temporary in nature, and our investment thesis in WD-40 remains intact.

Jordan: Julie, the last question I wanted to ask, especially seeing such a reversal from the end of last year, can you explain what impact stock quality from a characteristics perspective, things like S&P ratings, Debt Levels, or stock Beta had in the overall performance of the Small Cap Quality Value strategy?

Julie: The benchmark's performance was driven by lower quality names as described by lower S&P Quality Rankings (a measure of income statement quality), weaker balance sheets, and higher beta, certainly an unfavorable environment for us as high quality investors.

Here are some numbers to illustrate the point. Benchmark names with S&P Quality Rankings of B and below returned 14% during the quarter, well above higher-quality names (those with S&P Quality Rankings of B+ and above) which were up 9%. And benchmark names with higher financial leverage, long-term debt-to-total capital ratio of 30-70% were up nearly 15%, well above those with long-term debt-to-total capital of 0-30% which were up less than 10%. Finally, benchmark names with beta over 2 were up a robust 19%.

Contrast that with our portfolio where nearly 60% are in names with S&P Quality Rankings of B+ and above (twice that of the Index), nearly 18% boast debt-free balance sheets (versus 6% for the Index), and where we have no names with beta in excess of 2.

Jordan: Once again, I'm speaking with Julie Kutasov, Senior Portfolio Manager of the Kayne Anderson Rudnick Small Cap Quality Value Portfolio and hearing her thoughts on the first quarter 2019. Thank you again for your time and valuable insight you bring to our KayneCast listeners.

Julie: Thanks Jordan.