KayneCast

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Episode 80

First Quarter 2019 Review of the Small-Mid Cap Core Portfolio

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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 Small-Mid Cap Core strategy. And today we're going to discuss the First Quarter of 2019 performance.

Julie: Hello, Jordan, happy to be here.

Jordan: Julie, thank you for taking the time. We have seen quite a reversal in the broader markets to start 2019. Can you walk us through the performance of the Small-Mid Cap Core strategy during the quarter, along with comparable 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 2500 Index increased 15.8% driven by technology, healthcare, and energy sectors while consumer staples, utilities, and financial services 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 accounted for a roughly 6% weight in the Russell 2500 Index and posted a lagging 8.6% 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) represent a nearly 11% weight in the Russell 2500 Index and posted an impressive 16% return in the quarter. We have a structural underweight exposure to both banks (one holding at this time) and REITs (currently none) due to these segments' inherent capital intensity and low competitive differentiation. As such our lack of exposure to the outperforming REIT segment was mitigated by our lower exposure to the underperforming banking segment.

The Small-Mid Cap Core Portfolio underperformed the Russell 2500 Index by roughly 40 basis points during the first quarter with strong stock selection in the financial services sector more than offset by unfavorable stock selection in the healthcare and producer durables sectors.

Jordan: As we take a deeper dive into the actual strategy, what were some of the key contributors you saw for the portfolio during the first quarter?

Julie: The sector that contributed the most to our performance was financial services driven by strong performance by MSCI. Importantly, our strong absolute and relative performance in financials was archived despite our lack of exposure to the REIT segment which, to a great extent, drove the benchmark's financial services sector's performance during the quarter.

MSCI is a leading global provider of investment decision support tools (including indices) as well as portfolio risk and performance analytics products and services. As the preeminent provider of indices for international investing strategies, the company remains a beneficiary of the increased investment in non-U.S. markets and the shift from active to passive strategies. Shares declined along with the broad market sell-off at the end of last year. However, despite these headwinds, MSCI was able to grow revenue in the most recent quarter. Investors are also excited about the company's ESG (which stands for environmental, social and governance) investing market opportunity-a rapidly growing segment where MSCI holds a leading market positioning. The company is also one of our highest contributors for the trailing twelve months period.

Our second highest contributor in Q1 was a technology name - Aspen Technology (ticker AZPN). The company is also one of our highest contributors for the trailing twelve months. 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. Demand for Aspen's core platform remains strong, and the company continues to deliver solid profitability while maintaining a healthy under-leveraged balance sheet, producing a solid free cash flow stream, and returning excess cash to shareholders in the form of opportunistic share repurchases.

Our third 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 last year.

Jordan: And Julie, on the other-side what were some of the key detractors you witnessed during the first quarter for the Small Mid Cap strategy?

Julie: The sector that detracted the most from our performance during the quarter was healthcare driven by AMN Healthcare Services (ticker AMN). In addition, over 5% of the Russell 2500 Index is in biotech names - the segment that clearly does not fit our high quality investment style but posted a robust 26% return during the quarter driving an impressive nearly 20% return for the benchmark's healthcare sector.

Some of you may recall that AMN was among our top performers last quarter. The company is a leading provider of healthcare workforce solutions and staffing services. It's an established leader in a large healthcare staffing services segment, yet still holds a modest share of this fragmented marketplace. Shares suffered following some execution missteps in the company's locum tenens business. We view these self-inflicted problems as temporary and expect the segment to recover this year. Longer-term, we continue to 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.

Jordan: Julie, the last question I have for you is as we look back at Q1 2019, can you explain what impact stock quality had from a characteristics perspective, things like S&P rankings, debt levels, along with stock beta had on overall performance of the portfolio and also as it related to the index as well?

Julie: The first quarter's 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 16.5% during the quarter, well above higher quality names (those with S&P Quality Rankings of B+ and above) which were up 12%. And benchmark names with higher financial leverage (long-term debt-to-total capital ratio of 30-70%) were up 17%, above those with long-term debt-to-total capital of 0-30% which were up less than 14%. Finally, benchmark names with beta over 2 were up a robust nearly 27%.

Contrast that with our portfolio where 55% are in names with the S&P Quality Rankings of B+ and above (twice that of the Index), 17% boast debt-free balance sheets (versus 11% for the Index), and where we have no names with beta in excess of 2.

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

Julie: Thanks, Jordan.