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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

AI Among Tailwinds Propelling Large Cap Value Stocks

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SECTOR — GENERAL INVESTING

TWST: Last year was the 40th anniversary of Kayne Anderson Rudnick. What do you think is helpful for readers to know about the firm's history over those years, and the business as it looks today?

Mr. Sherry: The firm was founded back in 1984. It was two very successful businessmen based in Los Angeles, John Anderson and Ric Kayne, and they put their money into the business. The focus was on growing capital but also preservation of capital, so a growth mindset but also a conservative preservation-of-capital mindset.

That permeates everything that Kayne Anderson Rudnick does today, and that is, we want to outperform our respective benchmarks but to do so with less risk, whether that's downside protection or lower standard deviation.

What we've done over the years is consistent in the fact that we want to invest in high-quality businesses and let the business results drive the investment results. And when we say high quality, we're thinking about businesses that have a sustainable competitive advantage, strong balance sheets, and the ability to generate strong free cash flow through a full economic cycle.

That has been consistent throughout the 40 years that the company has been in existence, across all our strategies, from small to large, domestic and international, value and growth.

TWST: With the firm's emphasis on quality, I was going to ask about how that is defined and evaluated. Is there anything you'd add about that? Also, why is it important to emphasize?

Mr. Sherry: Over the years, we've found that if a business has a sustainable competitive advantage, it's likely to deliver strong results.

Our approach is forward-thinking: Will this company pass our screens 5 and 10 years from now? Meeting our standards today is just a starting point. From our perspective, a company can only truly be successful if it can maintain that strength over the long term, which is a key part of our process.

I think that's a little bit different than what you see in the rest of the industry. When others look at quality, it tends to be more backwards looking; they do a little bit more, I would say, basic research to understand what's worked well in the past. But our focus is much more on the future and making sure that it will, like I said, pass those screens in the years to come.

And so that's where we start to look at things like business models, and what are some of the things that will allow a company to do well in the future. Do they have a unique set of assets? Are there high customer switching costs? Do you get designed in with your customers? Do you have route density which prevents new companies from coming in and competing against you? Or do you have some kind of structural cost advantage?

Those are the kinds of things that we look for to give us confidence in the future of a company.

TWST: Let's home in on the Large Cap Quality Value portfolio that you manage. How does that overall investment philosophy and the emphasis on quality get applied to the strategy? What is the research and stock selection process?

Mr. Sherry: If you think about the broad spectrum of where you can invest, on one side you've got growth, you've got companies that have open-ended growth opportunities and they're growing faster than the economy.

And then on the value side you tend to have companies that have more GDP-plus-or-minus kind of growth. But then within that subset, you do have a lot of what I would call lower-quality businesses, where the businesses are cyclical. They don't have any pricing power, they're probably selling commoditized products, they're capital intense with poor balance sheets, they don't generate a lot of free cash flow.

We don't look at those. They're in the value benchmark, but they create volatility, and they tend not to outperform over the long term.

Instead, we look for the companies that are in that subset that are growing, compounding, and providing consistent growth over the long term. It's that quality space within value where we spend our time. So, within that universe we aim for what we believe are the highest-quality businesses and then create a diversified portfolio of 25 to 40 names with exposure to different economic sectors.

Ultimately, our goal is to create a portfolio that generates the results that I talked about earlier, which is outperformance with less risk.

In our experience, risk reduction/downside protection comes from the resilient earnings profiles and strong balance sheets of the businesses that we own in the portfolio. They tend to have earnings that hold up better during an economic downturn, which in turn contributes to stocks that tend to hold up better when the economy slows down and markets begin to dip.

TWST: Can you tell us about a few ideas from the portfolio's holdings and how they meet your investment criteria?

Mr. Sherry: Yes. One company is **TJX** (NYSE:TJX). They own TJ Maxx and Marshalls. Their same-store sales growth has generally been 2% to 5%, and they've remained consistent and within that GDP-plus-or-minus range that I talked about earlier. An attractive thing about the business is that you tend not to get big swings in their results.

They're a little bit old-fashioned; they don't have a huge online presence. But what they do have is 20,000 buyers around the world that buy excess inventory, whether it's directly from vendors or from department stores and other competition, and it allows them to produce consistent results that are difficult to replicate.

This model allows them to buy close to consumption, which mitigates fashion risk and markdowns. It also creates a treasure hunt component when shopping at their stores, which is attractive to many shoppers.

So, year in and year out they produce strong results, and you see that in the earnings, which in turn you then see the impact on the stock price.

Another is **O'Reilly Automotive** (NASDAQ:ORLY), an auto parts distributor that supplies parts to both mechanics and individuals. They've produced positive comparable same-store sales growth every year since they went public in the early 1990s.

If your car breaks down and you go to a mechanic, or you want to do it yourself, you want the part right away. Nobody wants to wait more than a day to have their car fixed, and so they've got this exceptional distribution network where they replenish stores five times a week. The parts are always there. They have the network, they have the distribution, and they produce solid results.

A more recent purchase is **Bank of New York** (NYSE:BK). This is a custody bank. They get involved when securities are first issued and subsequently traded, whether they are stocks, bonds or other securities. They also own Pershing, which helps broker/dealers and wealth managers with their holdings.

Historically this industry was not the best, meaning that you had all these little silos that didn't work together, didn't talk to one another, and didn't cross-sell their products. But **Bank of New York** added new management a couple of years ago, and they've really broken down those silos and created more of a platform where you can do more cross-selling, which gives them some pricing power. It creates stickiness with their customers, which you can see in their results.

So, based on our research, we liked what we saw. In an industry that historically has struggled to produce attractive returns, we see a bank where only about 25% of their business results require results that are tied to asset growth, like you would see in a typical bank, so that creates upside in terms of return potential that you don't often get with a bank.

I can give you a few more ideas if you'd like.

TWST: Sure, go ahead.

Mr. Sherry: I'm going to deviate just a little bit. Historically, technological disruptions make things faster, cheaper, better, whether you're thinking about PCs, the internet, the cloud, they tend to be detrimental to larger established businesses. Smaller, nimbler companies can generally better exploit new technologies.

AI is a little different because what you need in order to be successful is data and capital, and that's what you see in large-cap companies, and you see a lot of that in what you would think of as large-cap value companies, the ones in that GDP-plus-or-minus growth area.

So, for example, in the industrial space — and this is sort of incidental to AI — you're seeing this with **Eaton** (NYSE:ETN), which does power management. That's not only building out facilities for the economy broadly, but they benefit from data center builds.

Or you have **Trane Technologies** (NYSE:TT), which manufactures commercial HVAC equipment, where their products allow buildings to be more energy efficient, and so that's also in strong demand for AI and data center related businesses.

The other thing that I'd point out is that as you're building out facilities within the tech space, you can see companies like **Oracle** (NYSE:ORCL) or **Broadcom** (NASDAQ:AVGO) doing well in the AI space in terms of building out and managing data centers.

Regarding **Oracle**, you're seeing that what they built for their database business turned out to be ideally suited for AI. As they were going through a cloud transition, where they were admittedly a little late, it gave us an opportunity to buy at an attractive price. Like I said, we own businesses for the long term. We saw the opportunity there, and then they did make that transition successfully, and they've also had the AI part of their business doing well.

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Then there are the companies that are benefiting from using AI. In terms of utilizing AI, it's beneficial to be big, you need to have the data, and you need to have capital. **Waste Management** (NYSE:WM), the trash collection business, is an example where they can use AI to better manage their workforce and routes, and it gives them an advantage relative to their smaller, mom-and-pop competitors. We're seeing them really start to pull away from some of their smaller peers.

So, AI has become a tailwind. But instead of in the past, when a smaller, nimbler competitor might come after an established player, now with AI you're seeing it the other way around, where the larger established players are using AI to pull ahead from the smaller players that in the past might have interrupted their business model.

We're seeing that today in the large value space, where historically you didn't typically see that type of impact when technological change happened within the broader economy.

There are a lot of positives going on in terms of AI, but in addition to that, you're seeing things such as nearshoring, reshoring, and a lot of capital spending going on in the U.S. economy, and that's benefiting our businesses as well.

Going back to **Eaton**, or even **Trane**, which I talked about earlier, when you're building new facilities today, they're much more complex than they were in the past.

A few decades ago, if you were building a new factory, it was a bit more of what I would say was a "dumb building," much more basic. Now when you have to build a factory, you have to deal with many more considerations: I'm going to have Wi-Fi everywhere; my employees will have electric vehicles, so I need to have charging stations for that; I might have micro grids with some solar panels; I've got robotics, and I have to manage all that. For all of that, you need to be a company like **Eaton**.

Trane, on the other hand, gets involved in HVAC equipment for new and existing buildings. It might be a little bit more expensive upfront, but boy, they save you a lot of money in the long run, because so many buildings waste energy. And so, you pay up a little bit, but your energy consumption will go down a lot, much better than if you tried to do it on the cheap.

So, you've got AI, electrification, energy management, onshoring, reshoring. And then the last tailwind I might mention would be in aerospace and defense. You're seeing a lot of the European countries especially, having to spend more on defense. I believe that should bode well for larger companies in the defense space, like **General Dynamics** (NYSE:GD), whether it's munitions, armored vehicles, things like that, where you have exposure to that tailwind in this sector.

TWST: Your portfolio's turnover is in the range of 25% to 35%. What typically prompts a change in the portfolio in terms of exit strategy and your ongoing portfolio management and review of holdings?

Mr. Sherry: Ideally, when we make a purchase, we'd like to own it forever. As I mentioned earlier, we want to let the business results drive the investment results. If we're correct with our thesis and it keeps doing well, we will want to continue to own it.

Occasionally the stock will get a little expensive, and maybe we'll use that as an opportunity to trim it a little bit. Or it goes out of favor for a brief period, and we disagree with the market in that respect, and we want to add to it. So, that creates a little bit of trading activity.

Part of our process is to constantly be out there looking for new ideas, and occasionally we'll come across something that is better than something we already own. We bought **Trane Technologies**, as I mentioned, a few years ago. It was originally part of **Ingersoll Rand**. They were in the process of separating that business into two separate businesses.

When conducting our initial research on the company we really liked **Trane** and the fact that this was going to be a pure standalone business. We said, "This is a better business than something else we have in the portfolio, and we need to make space for it." So, sometimes it's not necessarily that something is wrong with the business that we own, but that we find a better opportunity.

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But there are also times when we look at the business and it hasn't met our expectations. Sometimes something changes in the industry, in the sector, that means that it's not as attractive as it was when we originally purchased it.

We have a process whereby if a stock goes down 20% or more relative to the market — where it's basically the market saying, "Hey, something is wrong here" — we circle back and take another deep look at the business and ask, why did we originally purchase it? What did we like about it? Has anything changed, and what do we want to do about that?

Do we say, "OK, you know what, something has changed, we don't want to own it," and we sell it? Or we say, "no, there's just some undue pessimism here," and then ideally, we want to add to the position and get a bigger weight.

Those are the main reasons for activity. There are a lot of good businesses out there. Our job is to find them. It's not just the Mag 7 that's doing well today. There are a lot of stocks in our universe, in our portfolio, that have done well this year. Our task is always to find those. They're there. We go out and we look, we do screening, we attend conferences, we talk to management teams, to understand what else might be out there and to always be open to finding new ideas.

TWST: Can you point to some recent contributors and/or detractors to the portfolio's performance?

Mr. Sherry: If I'm thinking this year, year to date, a lot of the ones that have done well have had some kind of AI exposure. And almost all of these we purchased years ago not knowing about a potential AI tailwind.

Amphenol (NYSE:APH) is probably our highest contributor this year. They make connectors, not a connector that you or I might do anything with in our house, but something that might go into a fighter jet or an industrial application, where if something breaks down you don't want to have to go in and fix it. So, they work very closely with their customers. It's a decentralized company. But connectors are also very important in building out data centers.

We bought it years ago. As we see it, the core business is doing well, and then you also have some data center/AI exposure.

Two other companies that have been some of our largest contributors are **Oracle**, which, as I mentioned above, has been experiencing a bit of an AI tailwind, as well as **O'Reilly Auto**.

On the flip side, a couple of companies that have been detractors and that we've sold somewhat recently, where AI has been a bit more of a concern, are **Accenture** (NYSE:ACN) and **Wolters Kluwer** (OTCMKTS:WTKWY).

Regarding **Accenture**, in terms of how AI may impact the consulting business, it's not going to make it go away, but on the margin, it may impact how much activity they get and the pricing they get. As for **Wolters Kluwer**, which is a database company, there were some AI entrants coming after some of their business that concerned us.

performance in value relative to growth in those time periods, but then you had big opportunities in growth.

What I'm seeing today, and I gave you some examples earlier, is more upside in large value because of the tailwinds that I mentioned. You've got this technological disruption that is not horrible for large mature businesses, and in a lot of cases is relatively advantageous for them. And then you're seeing reshoring, nearshoring, electrification. Those things are more tailwinds for large value stocks than we've historically had in these kinds of growth environments.

I think it's positive for large cap in general, and quite advantageous for large-cap value stocks, as long as you're looking at the higher quality ones that can put capital to work, get strong returns on that capital, and compound their returns over time, as opposed to more cyclical businesses that sell commoditized products into the spot market, which we tend to stay away from.

So, I'm quite positive about large cap in general, for the reasons that I mentioned, and also about large-cap value in particular. And if we do get into any kind of a bursting growth bubble or concerns about the economy, I believe the businesses we own tend to be quite resilient.

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And so, those were a couple where we looked at what was going on after some underperformance and said, "You know what, we're not comfortable that this will pass our screens, be a strong stock, in the next three to five years, so we're going to move on and put our capital elsewhere."

Another detractor, **Marsh & McLennan** (NYSE:MMC), which is an insurance brokerage company we've also owned for years, was a little bit weak recently in terms of activity and top-line growth. They help provide insurance to broad parts of the economy, so as the economy slows down a little bit — you've seen that somewhat over the past year or so, as we're dealing with tariffs and whatnot — their business has slowed a little as a result, which has caused the stock to underperform.

But we know that if you own a company long enough, you see these cycles, and say, "OK, it's underperforming now. I believe it's going to do well at some point in the next year or two."

TWST: How would you characterize performance of large-cap investments in general, and large-cap value in particular, in different economic and investment market environments, including where we sit today?

Mr. Sherry: There's always been a lot of press, especially recently, about growth doing so much better than value. When you have this growth tailwind that we have, especially right now with AI, and going back 20, 25 years or so, value will do well in periods where there's a bit of a bursting of the growth bubble — whether it was after the dot-com crash in the early part of this century, or even just a couple years ago post COVID and growth stocks got hit. You'd get a strong

I've mentioned some AI tailwinds, but a lot of their business models are fairly resilient, not as exposed, which can give you protection if we do get into any kind of slowdown in the economy or a slowdown in what's going on in AI in the tech world.

TWST: You've mentioned generally staying away from businesses selling commoditized products. Are there any exceptions, or anything that might surprise the reader given what you said?

Mr. Sherry: In the material space, I have historically thought of that as a place where you might find a commodity chemicals kind of business, and that's one that can be capital intense because you must build a factory, but it's not very differentiated. You're selling commodity products out to the spot market, where you don't have any control over the price.

One way you can differentiate is perhaps you have a lower cost position, but then if someone else produces an even lower cost position, you're in trouble. And that's the kind of business that has historically been in the value universe.

Our focus is on businesses that might be differentiated/unique. One example is **Vulcan Materials** (NYSE:VMC), which is an aggregates business. Talk about unique assets; you can't transport aggregates very far, so you do have pricing power. It's difficult to come in and compete if you don't have those unique assets. You can't outsource this to China or anything like that.

Another example is **Linde** (NASDAQ:LIN), which is an air gas company. It's capital intense, but they're not producing something into a spot market. It's capital intense in that they build an air separation facility for, say, a steel company or a refinery, and they take the air that's all around us and break it into oxygen, nitrogen, a little bit of argon. And whatever the customer doesn't use, they take, for example, oxygen and then they'll ship it to, say, the local hospitals.

They have agreements with the hospitals nearby, and then they share the economics with the customer. It makes it very difficult for someone to come in and compete against them, because they don't have all those relationships with the hospitals.

But the other thing that I believe makes it a good business model is when they build this facility for the steel company or the refinery, they say, "You can pay us a fee to manage this, or we can structure a take-or-pay agreement, where there's a minimum that you will have to pay us, so even if your business slows down a little bit, there's a certain amount that we get paid." So, it's capital intensive because you must build this big facility, but you have a bit of a guaranteed return.

And so, you have a business that grows over time as you're building these facilities, but you don't have a lot of downside risk. If the economy slows, you have this minimum, a floor, so that your revenue, your earnings, don't go down dramatically.

That's the kind of business in a very cyclical space that we focus on. We stay away from the commoditized kinds of businesses that have no pricing power, and we're looking for something that is special, unique, difficult to replicate.

TWST: Is there anything else you'd like to talk about to conclude?

Mr. Sherry: This comes up when I talk to people about why we're different. When I started in the industry 30 years ago and you thought about large value, you tended not to think about quality. You had much more of those cyclical businesses that I mentioned. Over time, as the economy has evolved into more of a service kind of economy, we've seen things in the value space that tend to be higher quality and we've seen more interest in quality within the value space.

But what I've noticed is, when people think about quality, what they'll do is create a screen that's backwards looking. They'll put a valuation overlay to help point them in the right direction of where to go, and then they'll do some basic, fundamental research to make themselves comfortable with the business.

Our approach, like I said, is somewhat different. We spend some time screening, looking for new ideas, but a lot of the focus is about the future. It's not about the current quarter or the rest of this year. It's about, how do I get confidence that this is going to be a good business not just today but five years from now, 10 years from now?

So, we focus on fundamentals, business models, and business characteristics. I think you don't see that as much when you look in the quality space, especially in value. You want to be open to when things are changing. You've got to be aware that things might be a little bit unsettled at times.

By taking the approach that we do, to be more forward looking, I believe we can continue to achieve that risk/return objective better than what I've seen with a lot of our peer group in this space that are trying to do the same thing.

TWST: Thank you. (MN)

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