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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

E-Commerce, Enterprise Software Positioned to Reaccelerate Growth

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SECTOR — GENERAL INVESTING

TWST: To start, tell us a bit about Kayne Anderson Rudnick's history and its business today.

Mr. Armbruster: Kayne was founded in the mid-1980s. We have expanded the scope of our capabilities to include small cap, mid cap, large cap, and everywhere from value to core to growth. But the unique feature of our firm is that we have the same investment discipline across all of our strategies, and that's one of a disciplined application of owning high-quality companies in relatively concentrated portfolios over long periods of time.

Our founders defined risk as total loss of capital rather than things like tracking error or beta. So we are intensely focused on understanding the drivers of a business, how they're differentiated, and how that's sustainable over time.

Once we understand that, then we try to understand how those qualitative characteristics result in the quantitative metrics that any high quality investor would want to own: high and sustainable margins, good cash flows, high returns on investment.

We believe that owning these differentiated companies over long periods of time will allow us to outperform our benchmarks, which contain a mix of higher- and lower-quality companies.

TWST: What would you add in terms of your research, stock selection, and portfolio construction process?

Mr. Armbruster: We're very bottom-up, fundamentals-oriented investors. We spend much of our time studying businesses, looking for business characteristics that are differentiated.

In terms of our portfolio construction, it's very organic in that we're looking for good ideas, regardless of what sector or industry they might be in. We don't ever go out and say we want to own more health care or more financials and then let that drive our search for new names.

When it comes to portfolio management, we like to own a concentrated portfolio, so 30 to 50 names. We have relatively low turnover, something on the order of 20% per year. When we find a good business that we think has durable advantages, we like to own that for long periods of time. Our average holding period is somewhere around five years, but we've held some stocks for a decade-plus.

On an ongoing basis, when we think about portfolio management, especially for the large-cap growth strategy, we like to water our flowers and pull our weeds.

So stocks that are beating estimates, where the growth story is playing out even better than we expected, the company is leveraging its advantages to grow in ways that were unexpected by the market — those are our flowers, and we'll typically add to those as they grow.

On the other side, our weeds are names that are missing estimates, that are struggling to maintain the growth or the margin profile that we saw when we invested in them, the advantages that we saw might not be as durable as we initially concluded.

We're more likely to pull those out of our portfolio, rather than try to dollar cost average or trade our way out of a position.

TWST: How do you define or quantify "quality," which is a term many folks use but may or may not mean the same thing?

Mr. Armbruster: It's rare that you find an investor say that they aren't buying quality, that they're buying bad companies and hoping they become better companies.

I believe the way we look at quality, the way we've institutionalized the study of business models, is really differentiated. We're looking for characteristics that we've found over time have led to stronger, more differentiated businesses.

Examples include things like a network effect, or a product being designed into a workflow or another customer's product, or a sticky

customer relationship, which you find oftentimes with software, where once it's installed there's very high switching costs to change that out to a competitive product.

By understanding the qualitative drivers of the quantitative metrics you find the vast majority of quality investors looking for, I think we can better understand how sustainable and predictable they are going forward.

Anybody can look at a FactSet screen for certain quantitative metrics that indicate quality, but unless you really understand what's driving those metrics, I think it's hard to have confidence that these "quality" businesses are going to maintain those quantitative characteristics over time.

TWST: Let's talk more specifically about your Large Cap Sustainable Growth strategy. Could you give us a broad snapshot of the portfolio?

Mr. Armbruster: As you might expect with a large-cap growth portfolio, a large part of our portfolio is made up of information technology, consumer discretionary, and communication services names. These names tend to be what most people would consider tech-first or tech-focused companies.

companies able to grow expands, you could start to see performance from a broader selection of securities rather than this narrow list.

And it happens because rate increases do act as a restraint on the ability of smaller companies to grow. It constrains access to capital for them and for their customers. I think it also impacts overall sentiment, which can also curtail broader demand.

So, as there's clarity to the end of these rate increases, you could see the business environment for companies outside of the Magnificent Seven really start to improve, their growth to inflect, and for those stocks to catch up in terms of performance to this very narrow group of names that have been leading the market.

TWST: Are there any particular areas that you're seeing the best opportunities right now? Not that you're necessarily pursuing a specific sector or industry, as you noted, but that you're finding there is a trend.

Mr. Armbruster: Right, you accurately stated that we're not really looking for a specific area to outperform. But to answer your question, I would say that there are a couple of areas that have really gone through a period where demand has reset, like e-commerce and enterprise software.

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We also have a relatively healthy amount of financials by virtue of our large position in a global credit card service corporation.

With this portfolio specifically, we're a little bit under-indexed to the Magnificent Seven that have been a driver of performance for the broader market for the last year-plus — I would say an outsized driver of performance for the last year-plus. I'd like to get into some of those numbers, because I think it's been fascinating and it's a really interesting market dynamic at this point in time.

TWST: Yes, please go ahead.

Mr. Armbruster: If you look at the Magnificent Seven, they're all great businesses, they have the ability to generate tremendous free cash flow, and they can invest that in new growth optionality, like most of them are currently doing with artificial intelligence.

That group is up significantly year to date and accounted for something like 80% of the S&P 500 returns for the year.

If one were to consider those seven companies as their own sector, they would represent 28% of the S&P 500, which is 15 percentage points greater than the second largest sector, financials. If you take that a step further, the weight of their earnings within the S&P is only about 17%. So, there's a lot of optionality implied in the valuation of this group.

But I think right now, as we get to the end of the Fed rate tightening cycle, it feels like, and it would stand to reason that, the market would start to broaden out. For a lot of people that have been hiding in these names, they've represented differentiated growth. Now as the list of

I think one of the earliest parts of the economy that started to rightsize their expense base was information technology. A lot of companies overspent during the pandemic on connectivity software, security software, things that they needed to allow remote work, and they had to go through a period of digestion, of normalizing that spend. We saw deceleration across a lot of our names, and I think we're starting to get some of the reacceleration there now.

I think similarly with e-commerce, during the pandemic you had a pull forward of shopper intent. E-commerce did disproportionately well versus some other parts of the consumer discretionary space. As the economy reopened, some of that growth normalized back to trendline.

I think that some of these e-commerce companies are well positioned now to reaccelerate that growth and to surprise to the upside versus some more cautious expectations for e-commerce growth specifically going forward.

TWST: Would you give us an example of some of your favorite investment ideas right now?

Mr. Armbruster: One company is a cloud-based e-commerce platform that allows merchants of all sizes to have an online presence. Instead of a marketplace model where the company maintains the customer relationship, by hosting your e-commerce operations on this company's platform, you as a company can maintain that relationship with your customers.

For smaller merchants, you can really scale your capabilities to compete with the largest ones, and for the larger ones, you really have a

lot more control over your online experience which can facilitate a better relationship with that customer.

We already talked a little bit about ecommerce re-accelerating, which I think will be a tailwind for the company. But most importantly for the company is its cost basis and its margins. Historically, the company had been investing in an incredibly capital-intensive fulfillment network. They saw what the competition did, they thought they needed to have similar capabilities.

But in June of 2023 they decided that they would be better off divesting those capabilities, or outsourcing it to another party, so they divested their fulfillment operations to an outside company and have partnered with them to maintain that offering on their platform for their merchants, but without having to invest all the capital to build it out themselves.

The company also had multiple reductions in force this year, and I believe it's well positioned now to show operating leverage and free cash flow generation that it's never really been able to do in the past. And, with the COVID comps behind it, I think that the combination of accelerating GMV growth with this margin expansion positions this company well to exceed expectations going forward.

TWST: Obviously the third quarter saw quite a bit of a pullback in equities. During that most recent quarter, what were your biggest contributors and biggest detractors, and did that lead to any adjustments to your positions?

Mr. Armbruster: In terms of top contributors, we had strong performance from a leading manufacturer of high-end graphics processing units and supplier of AI hardware and software, which is our largest holding. I think the drivers behind the company's success at this point are pretty well known.

From my perspective, they are the most important enabler of artificial intelligence compute capacity in the market. Demand for their GPUs dramatically exceeds supply, and with every company trying to build out AI capabilities, we believe that there's still quite a runway of growth ahead for the company.

Another one of our big contributors this most recent quarter was a health care company engaged in the discovery, development, and marketing of human health care products. I think second only to artificial intelligence, the GLP-1 interest across the market has grown exponentially. There are only two companies that have these drugs on the market, including the name we hold. They not only promise weight loss, but also a reduction in cardiovascular risk for patients that are taking them, and we've seen just tremendous demand for these products across many different geographies.

In terms of detractors, I would point to a company that provides a cloud-based human capital management (HCM) solution. It's an interesting story because they created a product that allows employees to essentially do a self-service payroll check, which reduces errors and saves HR and accounting teams hours of labor for checking and correcting errors and rerunning reports.

But it turns out it's a little bit of a double-edged sword, because the company actually earns revenue from some of those payroll reruns and mistake corrections that were the result of employees not doing their own payroll.

So now the company has decided it doesn't want to monetize this product. They felt like they would take a customer-first approach to proving its value and getting customers to adopt the product, which would create more sticky customer relationships.

They feel like over time they're going to be able to monetize it, but at the same time, it's a direct negative impact to near-term revenue in that they can't earn these extra fees.

So they missed expectations this most recent quarter, and I think the market needed to come to grips with that dynamic in their P&L and more accurately model that going forward.

In terms of changes that we're thinking about making to the portfolio, we didn't feel like any of the news or any of the moves of our existing names warranted any substantive changes in weights for the existing holdings.

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TWST: You mentioned that a leading manufacturer of high-end graphics processing units is your largest holding, but that more broadly you're underweight the so-called Magnificent Seven. Are there other areas you're underweight, or just generally cautious about today?

Mr. Armbruster: I don't have any areas that I would call out as places where I would be particularly cautious.

Maybe in the very near term, we've started to see some deterioration in consumers with low FICO scores, for example. I think you saw a number of credit bureaus call out some uptick in credit delinquencies among subprime or low-FICO consumers. So I think you could potentially see on the consumer discretionary side a little bit of weakness in that cohort.

But I think in general, most companies have been preparing for this recession that we are projected to have for a number of quarters now. And so, I think that if there is any sort of consumer-led recession it's going to be pretty shallow and pretty short lived, because, in my view, the companies themselves are well positioned to weather a shallow recession and get through it without too much of a deterioration in overall business health.

TWST: What triggers an exit for the portfolio? Describe your sell discipline.

Mr. Armbruster: Typically, it's going to be a deterioration in the fundamentals. There are one-off cases where a company gets acquired. We've actually had two energy names in this portfolio acquired recently.

But in general, we're looking for situations where we feel like the story has materially changed and that's leading to some deterioration in the fundamentals — whether it's growth rate or margins or free cash flow, there's something about the business that is struggling.

Sometimes we understand exactly what it is. Sometimes we have good theories, but sometimes it takes management a couple of quarters to accurately diagnose what's happening in their business and take the steps to properly remediate it.

TWST: In terms of an outlook for equities in general and for the macro environment, do you take that into account in addition to your bottom-up focus? What is your outlook, and what could that mean for large-cap growth investments and portfolios like yours?

Mr. Armbruster: Generally, I feel like many of our companies have already gone through a demand reset, and the ability to accelerate growth off of what they saw in 2022 and 2023 is relatively promising.

For growth stocks specifically, the end to Fed rate increases is going to be hugely important. These are long-duration assets. Higher interest rates naturally lead to lower valuations.

I think a lot of investors have been waiting for the end of Fed rate increases to properly value them, and if you get a combination of multiple stability and maybe multiple expansion on top of growth reacceleration, I think these stocks are particularly attractive.

Also for the growth portfolio, I think the tailwind of artificial intelligence is going to be a driver for innovation within the sector. We haven't seen a ton of companies that are able to really monetize AI — yet. But a lot of companies are investing in the capabilities and trying to understand how they can improve their product or service with artificial intelligence.

When you have a technology that is potentially this impactful, it really energizes innovation, and it energizes development teams and growth teams to create new products which can potentially lead to new growth opportunities. We're very constructive about how that's playing out.

Finally, many companies that we own really refocused on the operating health of their company. We saw a lot of these companies, especially on the information technology side, take a lot of costs out of their business, really tighten up their capital discipline, and so we have seen the profitability of a lot of these companies expand materially.

We think that is going to be incredibly important as we go forward: that these companies are starting to accelerate their growth, but from our perspective they're doing it from a much healthier operating expense basis and a much healthier cash flow generative perspective, which I think over time will lead to stronger companies and better equity performance.

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

Mr. Armbruster: Growth investing has been out of favor now for a couple of years, and for good reason: Fed rate increases, tough COVID comps, demand pull forward. But with these companies now facing easier comps, looking at growth reacceleration, having rightsized their expense base to be much healthier companies from a P&L perspective, and with the end of Fed rate increases on the horizon, I think now is an attractive time to refocus on growth equities.

TWST: Thank you. (MN)

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