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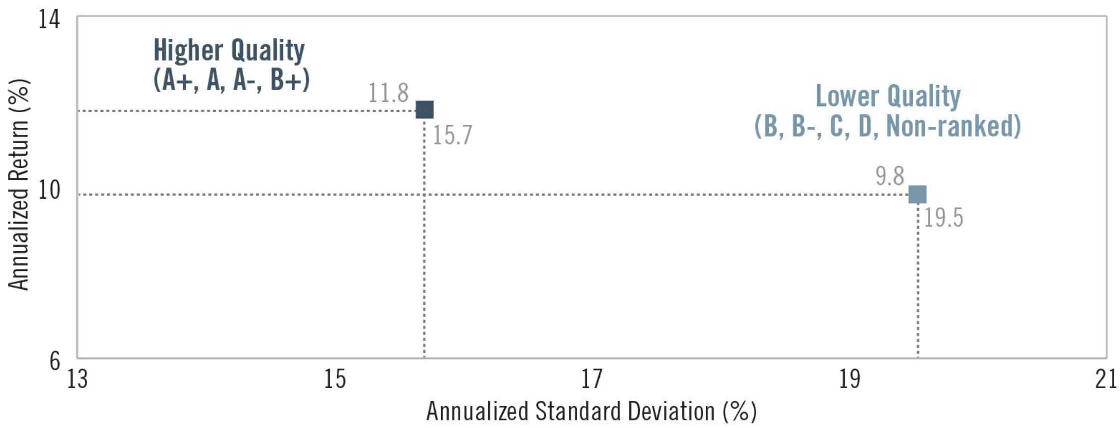
Thinking Beyond the Benchmark: KAR Small-Mid Cap Core SMA Portfolio

This article was originally published in 2020 and is updated quarterly. The current edition includes data as of March 31, 2024.

Betting on quality for better risk-adjusted performance

Quality businesses have an unmistakable profile: durable earnings growth, high return on capital, strong balance sheets and cash flows, and management acumen at maintaining a competitive advantage. These attributes sound attractive, but do they really make a difference? Virtus Investment Partners' affiliate Kayne Anderson Rudnick (KAR) believes they do. Since 1984, the firm has been guided by these principles, seeking to grow and preserve clients' wealth responsibly. Nearly four decades later, a focused commitment to owning quality businesses remains central to KAR's investment culture and the portfolios they manage today.

HIGHER-QUALITY SMALL-MID CAP STOCKS HAVE DELIVERED BETTER RISK-ADJUSTED RETURNS OVER 30 YEARS



S&P Quality Rankings of Russell 2500TM (Small-Mid Cap) companies, 3/31/1994-3/31/2024. Higher quality = B+ or above. Lower quality = B or below, plus non-ranked companies. Sources: S&P, FactSet, and FTSE Russell. ***Past performance is not indicative of future results.***

KAR Small-Mid Cap Core: A Distinct Focus on Quality

In the ongoing active-vs.-passive debate, data suggests the U.S. small-mid cap asset class offers ample room for skilled active managers to outperform. In KAR's view, instead of "active or passive?" investors would do well to ask themselves "high quality or low?" To that end, the KAR Small-Mid Cap Core SMA portfolio seeks to invest in the highest quality small- and mid-cap businesses. Since its 1992 inception, this focus on higher quality and lower risk measures has resulted in greater risk-adjusted performance versus the broader stock market.

In KAR's view, the quality of the underlying businesses held in a portfolio is a key factor in the consistency of investment performance and risk management. KAR believes that investing in quality businesses is an important contributor to lowering portfolio risk in an effort to capture greater risk-adjusted returns relative not just to the specific asset-class benchmark, but to the overall equity market. Quality and risk management may seem like secondary factors during periods when U.S. equity markets are advancing consistently and in particularly pronounced bull markets. However, quality companies tend to stand out when equity markets correct. It is especially during more volatile periods—when investors are looking for safety—that quality and risk management count.

Profiting from Profitable Companies

The KAR Small-Mid Cap Core SMA portfolio invests in the small-to-medium company universe and is benchmarked to the Russell 2500™ Index. It is a concentrated, high-conviction portfolio of 25-35 companies, typically held two to three years, often longer. Analyses of the strategy provide a clear view into how the quality of its underlying holdings affects the portfolio overall, and demonstrate the importance of quality and risk management in long-term outperformance. The table below compares KAR Small-Mid Cap Core portfolio companies against holdings in both the Russell 2500 (2,500 smallest U.S. companies in the Russell Universe) and the S&P 500 Index (500 largest U.S. companies). The KAR portfolio provides exposure to higher-quality small-to-mid cap stocks, focusing on businesses that have generated exceptional returns on shareholders' capital without employing significant debt, while getting smaller-company exposure at a level of earnings variance similar to that found in larger companies.

WHAT'S IN YOUR INVESTMENT PORTFOLIO?

Characteristics of Holdings	KAR Small-Mid Cap Core Portfolio	S&P 500® Index	Russell 2500™ Index
High-quality Stocks— % of Holdings with S&P Quality Rankings B+ or Above	61.3%	71.4%	34.0%
Profits— Return on Equity – Past 5 Years	24.3%	26.0%	13.6%
Debt Coverage— Interest Coverage Expense Ratio	8.0x	9.1x	5.8x
Debt— Total Debt/EBITDA	1.6x	1.2x	2.1x
P/E Ratio— Trailing 12 Months	37.6x	27.8x	32.8x
Volatility of Earnings— Earnings Variability – Past 10 Years	41.1%	48.9%	75.5%

Data as of 03/31/2024, obtained from FactSet Research Systems and BNY Mellon, and assumed to be reliable. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. ***Past performance is no guarantee of future results.***

Quality as an Offset to Volatility

Careful risk management is an important facet of KAR's investment approach. Stocks with smaller market caps are generally known for not only the potential to deliver excess returns over larger stocks, but also for potentially higher risk, commonly represented by standard deviation. The KAR Small-Mid Cap Core SMA portfolio, despite its focus on the small-to-mid capitalization range, has a risk profile equivalent to that of the S&P 500 Index. As shown below, the portfolio exhibits better return per unit of risk (standard deviation divided into annualized return) relative to both the portfolio exhibits better return per unit of risk (standard deviation divided into annualized return) relative to both the benchmark (Russell 2500 Index) and broader equity market (S&P 500 Index).

BETTER RISK-ADJUSTED RETURNS

	Annualized Return (%)	Standard Deviation (%)	Return/Risk Ratio
KAR Small-Mid Cap Core (Gross)	11.90	15.52	0.77
KAR Small-Mid Cap Core (Net)	10.47	15.52	0.67
S&P 500® Index	10.50	14.79	0.71
Russell 2500™ Index	10.43	18.12	0.58

Data presented is since the inception of the KAR Small-Mid Cap Core SMA portfolio, 4/1/1992-3/31/2024. Source: FactSet Research Systems and is assumed to be reliable. ***Past performance is no guarantee of future results.***

The return per unit of risk compares an investment portfolio's returns to the standard deviation of those returns, showing the relationship between performance and the risk associated with the generation of that performance. Thanks largely to the lower risk measures, the KAR Small-Mid Cap portfolio delivered better risk-adjusted returns over the observed years than its benchmark and many of its peers, and also outpaced most others in the small-mid cap universe in terms of annualized alpha and the Sharpe ratio.

Attractive Downside Capture

One final point: the KAR Small-Mid Cap Core SMA portfolio has consistently achieved a downside capture ratio of less than 100 over its lifetime, meaning it has lost less than the Russell 2500 Index during periods of negative returns for the benchmark. This is important because, at the end of the day, investors want a strategy that fulfills a beneficial function to their portfolio, whether return generation, risk mitigation, or a combination of both. Returns and risk must always be observed together, and KAR has been highly disciplined in balancing the two through a consistent focus on quality.

About Kayne Anderson Rudnick

Kayne Anderson Rudnick, an affiliated manager of Virtus Investment Partners since 2001, is an investment and wealth advisory firm whose unique high-quality approach is applied to an array of investment strategies, including small-cap (domestic, international, and emerging markets), small-mid cap, mid-cap, large-cap, all cap, and global yield strategies. Based in Los Angeles, KAR manages assets in open- and closed-end mutual funds and separate accounts for corporations, endowments, foundations, public entities, and high net worth individuals. KAR had $65.3 billion in assets under management as of March 31, 2024.

Risk Considerations: Equity Securities: The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small, medium, or large-sized companies may enhance that risk. **Limited Number of Investments:** Because the portfolio has a limited number of securities, it may be more susceptible to factors adversely affecting its securities than a less concentrated portfolio. **Technology Concentration:** Because the portfolio is presently heavily weighted in the technology sector, it will be impacted by that sector's performance more than a portfolio with broader sector diversification. **Market Volatility:** The value of the securities in the portfolio may go up or down in response to the prospects of individual companies and/or general economic conditions. Price changes may be short- or long-term. Local, regional or global events such as war or military conflict, terrorism, pandemic, or recession could impact the portfolio, including hampering the ability of the portfolio's manager(s) to invest its assets as intended.

This material is deemed supplemental and complements the performance and disclosure at the end of the KAR Small-Mid Cap Core SMA Portfolio presentation (https://www.virtus.com/assets/files/xh/smid-presentation_wrap_1q24_4004.pdf) .

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