



Kayne Anderson Rudnick

A VIRTUS INVESTMENT PARTNER

The Case for Quality

Executive Summary

INVESTING IN HIGH-QUALITY BUSINESSES is a time-tested approach that enables investors to increase their chances of capturing what have been historically stronger risk-adjusted returns. This is because high-quality companies tend to experience lower volatility and greater strength and consistency in returns over a market cycle, including the most difficult times. The combination of these factors can provide investors with valuable peace of mind.

From mid-2013 through mid-2014, lower-quality companies rebounded sharply from the recession while the high-quality segment lagged, as evidenced by the dominant performance of debt-laden businesses with low returns on equity. In part, this occurred because low-quality companies typically have the most to gain from improving credit market and economic conditions like those we saw during this timeframe. Low-quality companies are inherently more reliant on lower-cost capital because they can be more capital intensive and/or less able to finance growth through internal resources. However, the U.S. Federal Reserve's decision to end its QE (Quantitative Easing) program suggests that interest rates will not remain artificially low indefinitely, especially with the first increase in interest rates predicted to happen before the end of this year. A significantly less stimulating fiscal policy should return us to a more "normal" monetary environment. As we have seen in more recent periods, this will benefit those higher-quality businesses that are less leveraged and less dependent on the credit markets, and who have the financial reserves to continue self-funding their growth opportunities.

This tendency for high-quality and low-quality companies to inversely come in and out of favor in response to the economic and stock market cycle is sometimes referred to as the "quality cycle." Inherent in the word "cycle" is the idea that there may be short-term economic periods when high-quality businesses will experience relative underperformance. However, as long-term investors, we believe high-quality companies outperform over time and provide an important ballast for any investment portfolio given their financial stability across varying macroeconomic environments.

Investing in Quality Companies

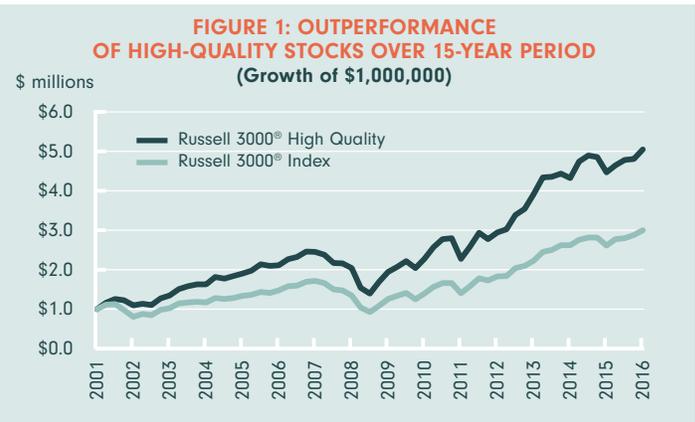
Quality investing looks beyond the traditional style boxes of market capitalization (large, mid, and small) and investment style (value, core, and growth). It is a more rigorous investment approach that employs in-depth, bottom-up qualitative and quantitative research which seeks to identify companies with outstanding financial and business characteristics, including both soft (e.g., competitive advantage or management competence) and hard criteria (e.g., high returns on capital or balance-sheet health).

While most investment managers exclusively focus on exposure to large or small cap, as well as growth or value stocks, the amount of exposure to high- and low-quality stocks can have as meaningful of an impact on a portfolio's long-term return. This is mainly due to high-quality companies providing greater financial stability and a greater propensity to grow across varying macroeconomic environments, which leads to more consistent returns over time.

Historically Strong Risk-Adjusted Returns

To understand this long-term advantage, consider the 15-year period—including the Great Recession—ended September 30, 2016 (Figure 1). During this timeframe, a \$1 million investment in the median of high-quality stocks (defined as those within the Russell 3000 Index that have a return on equity (indicates profitability) greater than 15% and a ratio of debt-to-assets below 30%) would have outperformed the Russell 3000 Index by 204% (405% versus 200%, respectively).

During this same timeframe, the annualized return for the median of high-quality stocks was 11.40% versus only 7.61% for the Russell 3000 Index. Further, the median of high-quality stocks experienced a higher risk-adjusted return with a Sharpe Ratio of 0.61 versus 0.38 for the Russell 3000 Index (Figure 2).



Data presented is for the period ending September 30, 2016. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

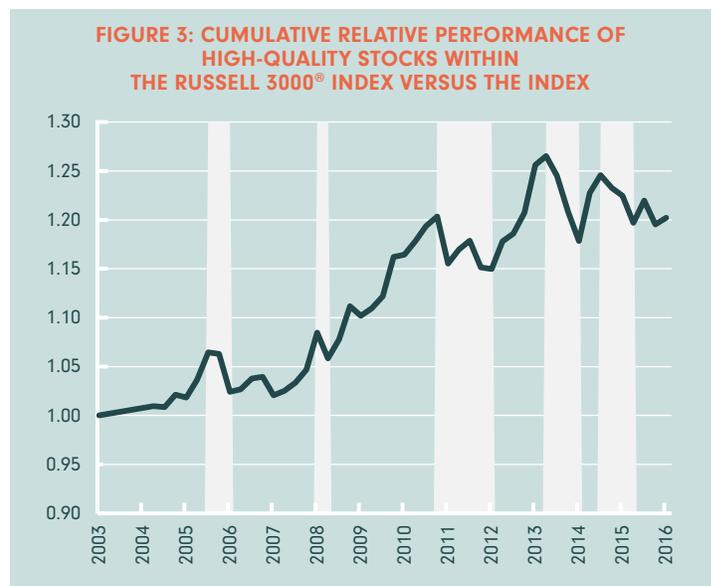
The Quality Cycle

When the economy slips into a recession, such as that of 2008 to 2009, low-quality stocks typically underperform high-quality issues.

However, when conditions improve, the market often experiences a shift into low-quality stocks. Sometimes referred to as “junk rallies,” these phases usually occur at the beginning and the end of a stock market cycle because low-quality companies have the most to gain (i.e., improving profit margins) from improving credit market and economic conditions. They are often more reliant on the debt markets because they are more capital intensive and less able to finance growth through internal resources.

As long-term investors know, rallies always recede. A look at the cumulative relative performance of high-quality stocks within the Russell 3000 versus the Index itself demonstrates how quality outperforms over time. In Figure 3, where the line ascends, high quality is outperforming on a relative basis. Where the line descends, high quality is lagging the benchmark.

Savvy investors also understand that markets are too complex and dynamic for anyone to be able reliably predict future price movements and thereby time the market as it transitions from a low-quality bias to a high-quality bias and vice versa. Rather, market timing—attempting to identify the best times to get in and out of the market by relying heavily on forecasts and market analysis—often results in being out of the market during its best performing cycles.



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Our Approach

THERE IS NO SHORTAGE of investment managers claiming they invest in quality, but most of them fail to adhere to the same standards of quality that we employ at Kayne Anderson Rudnick. Our goal is to create a portfolio of what we believe are the highest-quality businesses out there. We want companies that have a differentiated and sustainable competitive advantage within their industry, an advantage that creates favorable long-term growth prospects and profitability in both good economic times and bad. Typically, these are companies with strong free cash flow and returns on capital. We also look for management teams that are prudent and effective in allocating this capital. Lastly, our goal is to find these businesses at attractive valuations.

We begin by screening our universe of companies using quantitative metrics to filter out lower-quality companies. With these financial metrics in hand, we then focus on understanding the underlying business that is generating these numbers. We look for companies that have effective competitive barriers, such as an exceptionally strong brand franchise (think Nike or Coca-Cola), a unique cost advantage, a network effect, or high-customer-switching costs (their product becomes embedded in their customers' businesses). These companies have the ability to shape and control their own markets, and these unique business models are what drive strong financial results over time. Management sticks to the company's core competencies, cultivates the competitive advantage of the business, and allocates capital in a shareholder friendly manner, such as dividends and share repurchases.

Once we have tackled the qualitative side of the business, we conduct disciplined quantitative analysis of the company's financial statements. In our view, high-quality companies will demonstrate steady and consistent earnings growth, prudent debt-to-equity ratios, and above-average returns on invested capital. Meanwhile, low-quality stocks usually demonstrate erratic earnings, poor returns on capital, and substantial debt burdens. We then call management directly with our questions regarding these qualitative and quantitative issues. In this way, our proprietary research process helps produce an information advantage while managing risk in our portfolios.

If we do invest in a company, our plan is to do so for the long-term, knowing there may be short-term economic periods when our types of businesses will be out of favor. In the past, portfolios of high-quality companies such as those we manage at Kayne Anderson Rudnick have experienced short-term periods of relative underperformance. However, as long-term investors, we are resolute in our belief that high quality outperforms over time. We will not change our investment philosophy or approach even as market "fads" go in and out of favor. Rather, we will maintain our commitment to sound investment principles, including our steadfast belief that high-quality companies are an important ballast for any investment portfolio given their financial stability across varying macroeconomic environments.

To learn more about how strategies managed by Kayne Anderson Rudnick can help you pursue your goals, visit virtus.com or call 1-800-243-4361.

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*The **Russell 3000® Index** is a market capitalization-weighted index of the Russell Universe, which comprises the 3,000 largest U.S. companies. The **Russell 3000® High Quality** includes stocks within the Russell 3000® Index that have a return on equity greater than 15% and a ratio of debt-to-assets below 30%. The indexes are calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.*

Sharpe Ratio: A statistic that measures the efficiency, or excess return per unit of risk, of a manager's returns. The greater the Sharpe Ratio, the better the portfolio's risk adjusted return.

ROE (Return on Equity): The amount of net income returned as a percentage of shareholders' equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.