“Quiet Power of Quality Small Caps” Discussion
Featuring Jon Christensen, Kayne Anderson Rudnick
Moderated by Joe Terranova, Virtus’ Chief Market Strategist
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(Transcript edited for clarity)

Jon Christensen, CFA, portfolio manager and senior portfolio analyst at Kayne Anderson Rudnick, discusses the firm’s high quality investment approach relative to its Small-Cap Core strategy. The strategy is available to individual investors through the Virtus Small-Cap Core Fund and the Kayne Anderson Rudnick Small Cap Core separately managed account.

Paul Cahill: *Welcome. Thanks for joining us. My name is Paul Cahill, Managing Director of National Sales at Virtus Investment Partners and it’s my pleasure to serve as host. Joining me is Virtus’ Chief Market Strategist, Joe Terranova. I’m sure that many of you are familiar with Joe from his recurring role on CNBC’s “Halftime Program.” Joe, thanks for joining us. Also joining us is Jon Christensen, Portfolio Manager, Senior Research Analyst at Kayne Anderson Rudnick Investment Management, a Virtus affiliated partner firm. Jon is portfolio manager on several products including Small-Cap Core, Small-Cap Sustainable Growth, along with our Mid Cap Core offering -- all of which are five-star rated funds on a load-waived basis from Morningstar. It’s a pleasure to have him on to add perspective on the capital markets, talk about some investments in his space, as part of our ongoing efforts to help provide education and perspective to our clients. Joe, I’ll turn it over to you.*

Joe Terranova: *Jon, thanks for the opportunity to hear your comments regarding the portfolio and the capital markets. I think it’s important to begin talking about the topical headlines that could impact investor decisions and your portfolios. One of those headlines is the Federal Reserve’s desire to normalize interest rates. A lot of what we’ve heard over the last couple of years is that the small-cap asset class is probably most sensitive to interest rate volatility. Thus, with a possible normalization of rates coming, do you believe that to be valid/true, how do you manage it, and what’s your outlook regarding rates themselves?*

Jon Christensen: Thanks, it’s a pleasure to speak with everyone today and talk about us, as a firm, and how we do things. So, Joe, related to your questions, I think those are important and I think there are questions that are definitely coming up lately since we’ve been in an interest rate environment over the last few years that’s been very accommodative from the Fed with very, very low interest rates. When you think about Kayne Anderson Rudnick — I’m going to talk a lot today about quality and we’ll get more into what we mean by “quality” because everyone says they buy quality. No one says they buy “crap” (pardon my French) — Hopefully by the end of this discussion you will have an idea of what we mean by “quality.” And the interest rate sensitivity, when you think about that, Joe, typically let’s just take a rising interest rate environment, typically that has been in general good for small-cap stocks.

Why is that? Well, that usually means the economy's doing well, profits are growing, and therefore, overall corporations are doing better. But what we've seen lately is the opposite in the last couple of years, as I said, a lower interest rate environment. When we talk about quality and low quality, the small-cap space is made up of a lot of different names, but when you think about small caps in general, the high quality portion of that market is not very big. There's not a lot of high quality names in the small-cap universe. We do a lot of screening here based on profitability over the last five years, strong ROE, strong ROIC, and can take 9,000 to 10,000 names and get them down to about 300 or 400 pretty quickly, so the pond that we're fishing from immediately is already going to be very much smaller than the greater market.

Given that, our companies typically do not have a lot of debt on their balance sheet. They are usually growing through great free cash flow generation, so they're generating their own growth. They don't need the outside markets to be able to grow over time. During those times as we've seen when interest rates have been going down, they've actually been a nice tailwind for the lower quality part of the market. So now that we're seeing a stabilization and probably a subsequent increase in rates over time — when that will be remains to be seen — we believe that our types of companies will actually benefit from that environment even though in general small caps do better in a rising (rate) environment.

Why is that? Well, because our companies don't have to keep going to the debt markets to increase their debt to grow their business because higher interest rates means higher interest they've got to pay on their debt, so our companies have a tendency to do well in that rising interest rate environment.

I'm going to combine that with the fact that our companies right now in our portfolio, Small-Cap Core, are trading at about 10, 11 multiple discounts on P/E versus the rest of the [Russell 2000®] Index. So we think even though interest rates are going up and maybe economic progress may be happening, we think we will do better than that because a) Our valuations are lower; and b) our companies are not going to be subjected to the higher interest rate costs that the lower quality companies are.

Paul Cahill: *So if I were to look at your portfolio, I would have the understanding that the credit quality of the companies that you hold are at a higher standard and don't see the potential deterioration that we may have seen in the past in a rising rate environment.*

Jon Christensen: Exactly. And when you look at just our debt-to-EBITDA, for example, combined for our portfolio is 1.1 times. For the [Russell 2000] Index it's 10.4 times. So again, our companies have a lot less debt, and as you pointed out, are less subject to those interest rate rises.

Joe Terranova: Jon, do you think the distinction is on the individual companies or when we look at the portfolio, can you identify a particular sector where you maybe have an overweighting relative to another sector, an underweight sector? Again, we go back to the sensitivity and deterioration of credit, maybe has a little bit a of a higher debt assumption?

Jon Christensen: Exactly. That's a great point. I'll point out a couple of sectors — one, that we're overweight, and one that we're underweight. So one that we're overweight is producer durables — and everything I'm talking about her, this philosophy and the process and strategy and how we implement this, this applies across the board to all our portfolios. This is not just specific to the Small-Cap Core portfolio. And in general we find the producer durables sector weighting is typically overweight in most of our portfolios.

Why is that? Well, there are a couple of reasons. One is when you think about that sector, it's a very diverse sector. There's commercial services, consulting businesses, manufacturing and more durable companies, there's service companies, aerospace companies, and transportation companies. This sector actually used to be broken out several years ago by Russell and then they combined a couple of things that used to be in transportation, that used to be in auto, that used to be in consumer discretionary, and they moved it into producer durables. So as a result, it's very diverse, and we're able to find a lot of great businesses within that particular sector.

To give you a sense of the types of businesses we own – We own one company that's a salvage vehicle auction company. We own one company that is a consultant for product liability issues like the [Toyota] Prius issue — they are a consultant and an expert witness in instrument litigation. We own Landstar, which is a transportation logistics company. We own Teledyne, which is dealing with more aerospace and highly engineered products, and we own Toro, the landscaping company. So that's a sector where it's very diverse and typically we find great businesses in there. We typically have an overweight in that area.

On the other side, we're underweight healthcare right now. And if you think about healthcare, especially in small caps, the biotechs have a high weight within that sector. So as a result, biotechs for the most part, 95% of them, specifically in small caps, don't even make money, and we do not invest in companies that are not profitable or have not been highly profitable in the past.

So for us, healthcare has been an area where we've been a little bit more underweight due to the fact that we're not going to invest in biotechs and there are a lot of companies in there that are also subject to government reimbursement, which we are not fans of as well. We have a tendency to own businesses in there that are much more proprietary in nature which are value-add or privates take cost out of the system, high value-add, they have a tendency to resist a lot of things that I just talked about -- so that's just kind of typical for us.

Joe Terranova: *I've got to ask two questions and I think I know what Jon's answer is going to be, but Brexit, U.S. presidential election, are we taking the portfolios and obliterating them because of these two events, or are we sitting back and recognizing the reality that probably they're not going to have that much impact?*

Jon Christensen: Yes, Joe, it's going to be the latter. We've run this portfolio for over 23 years now and we've always stuck to how we run it and it doesn't matter, in our opinion, not that it doesn't matter on a worldwide basis, but for our portfolio, Brexit, really for us is not going to have an impact. Maybe combined in our portfolio, maybe 20% of the revenues in our portfolio are coming from Europe — so a majority of them are coming from outside of Europe and Asia and in other parts of the world as well. But for us, Brexit really is a non-event for us in how we run the portfolio and our positioning.

Same thing with the presidential election. It doesn't matter if Barack Obama is the president, George W. Bush is the president, or prior to that, we run the portfolio the same. We have a tendency to view that in the end, our daily lives and how businesses are run, we're in a "checks and balances" legislative system here. We have the President, Supreme Court, and the Congress — so no one person can really influence our day-to-day lives, except maybe more on a state or regional basis. So for us, it doesn't really matter what the election outcome is, we are going to continue to run the portfolio exactly as we have with our same laser focus on high quality.

Paul Cahill: *Can you take one step back and talk a little bit more about the history of Kayne Anderson and the development of that high quality process, and what goes into a high quality company? I know you mentioned some of the profitability return on invested capital, return on equity, but can you talk a little about the history and how that developed and just what is the foundation of that process at Kayne Anderson?*

Jon Christensen: We were founded in 1984 by Rick Kayne and Jon Anderson, the benefactor at the UCLA School of Business, self-made billionaire. He really established this firm and this is where we get our kind of research-intense, high quality roots. It came from Jon Anderson. He really wanted to run a high net worth company, but looking at public companies from a private equity standpoint so that's really where the high research intensity was developed from over time.

So for us, high quality — and getting to what you were talking about, we talked about ROA, we talked about profitability and all of that — but quality, for us, is really a business characteristic. Remember, the great numbers we were just talking about are generated by the business, not the other way around.

So for us, we're trying to find businesses that we believe have some sort of a sustainable, competitive advantage, businesses that can grow, protect, and nurture a market over long and multiple economic cycles — and for us, we have found that certain business models really lend themselves to that. One could be a strong brand, one could be a network effect, one could be a low producer, one could be high switching costs.

So if you think about these businesses, the one thing they share in common is that they're usually less capital-intensive businesses. They're not, "How big is our manufacturing facility? How much fixed costs can we put in the company?" It really comes down to some sort of intangible "secret sauce." And the reason that's important to us is when you think about those types of businesses that are low capital intensive, these are companies that usually have low fixed costs and high variable costs. So why is that important? Well, it's important to us because should there be weakness in or pressure in the economy or on a business, our companies' profitability will hold up much better because of that structure.

So I'll give you a couple of statistics that I think really bear this out. So in the 2001 recession, we had the S&P 500 earnings fall around 11%, the Russell 2000 earnings fell about 17-18%, the companies in this portfolio -- Small-Cap Core -- grew their earnings double digits. I'm going to fast forward to the 2009 recession. That's when we had the Russell 2000 earnings go to losses, the S&P 500 earnings fell about 18%. The companies in this portfolio -- Small-Cap Core -- earnings fell about 9% or 10% -- much better than the rest of the market -- and that's very important to us. And that's why when we talk to people we say, during a recessionary weak environment, we will hold up much better, we will preserve capital better than other people because of that, and that goes back to the quality of each business.

We're running a concentrated portfolio of small caps. So inherently people say, "Oh, small caps – risky. Concentrated -- risky." But by playing in that small-cap high quality universe, we mitigate that risk and it shows in our numbers. So in the last 23 years, the Russell 2000

Index, our bogey, has been negative eight years. The Small-Cap Core portfolio has been negative two years in that same time period. So that really tells you that if you're comfortable being negative every 2.5 years, then you invest in the Index. If you're comfortable with being negative every 10 years, you invest with us. So it really bears out that our way of doing things really is less risky given the perceived headwinds that we see.

Paul Cahill: *You can essentially add something that gives you the long-term returns of small caps and investors obviously need in their portfolios but with more of a risk profile that looks like their large-cap brethren.*

Jon Christensen: That's what we say. We say we want to give you excess returns of the asset class with less risk. But in the end, you're right. We've given them excess returns, but with the risk level of the S&P 500.

Paul Cahill: *You said earlier nobody says they buy 'crap,' so to speak. Everybody is buying 'quality.' Some of these quality heuristic elements, people would say are either fully valued or overvalued at this point in the market. How would you answer that, and how would you consider some of the valuations within your portfolios?*

Jon Christensen: So that always is the eternal question, right? Valuations in the end can determine a lot of things. But, if you think about it, in small caps, I gave you a statistic earlier generally, but if you look at our [Small-Cap Core] portfolio, the trailing 12-month P/E is 21.8%. For the [Russell 2000] Index, it's 32%. That goes back to what I was talking about at the beginning with valuations on the other part of the market, the lower quality part of the market, as much higher.

So for us, we're still finding these. We don't ever find companies dirt cheap, because with high quality businesses, there's no "fire sale" on them. You don't usually find them trading at 10, 11 times earnings. They're usually trading at more of a little bit higher multiple. But that's really where I think we add our value. We find these great businesses and then try to buy them at valuations that we believe are reasonable, but still maybe they're disconnected with how we think the future outlook is. If we think that the future outlook is higher than what's out there, then we will obviously be shareholders in that company.

So for us, that's why we like where we're positioned going forward because we think in that rising interest rate environment, the ones that already have higher valuations, we think those will have more headwinds whereas we think that our companies at lower valuations who will continue to grow at that sustainable level, we think that's why our portfolios will continue to do well, especially in this type of environment.

Earlier I talked about in a weak economic environment, we will do well. Coming out of a recession when the markets are embracing risk, we probably won't keep up, because our companies didn't get hit as hard and our companies aren't speculative.

But in a third environment, which is kind of what we've been in, a more benign GDP environment absent any sort of Fed intervention, worth much more of a stock picker's market where companies can distinguish themselves through solid and consistent returns, that's another environment where we should flourish – and that's, indeed, what has happened lately. We can see that continuing, given everything we talked about, especially with the rising interest rate environment. So valuations overall for small caps may be a little bit pricey, but where we are in our particular niche, we're very happy with where we are right now.

Joe Terranova: *If we can get maybe an understanding. Small caps quarter-to-date have done well relative to the S&P itself or the Dow or the NASDAQ. A lot of that might just be on the significant recovery that we're witnessing in energy and natural resource pricing. Your strategy, how much of a focus should there be for the investor upon what occurs in energy and natural resource pricing for your portfolio?*

Jon Christensen: Yes, it's a question we get a lot. If you think about it – after what we just talked about with the capital intensity that we like to kind of stay away from – energy is an area that typically we don't participate in a lot, given what I just said. If you think about energy companies, typically they are capital intense businesses, they're tied to a commodity price, which, as you know, is very difficult to predict where that's going to go, but we like to find sectors that have gotten hit hard and we like to find companies within those sectors that we believe have gotten hit unfairly in our distinct businesses within that sector.

So, for example, in the Small-Cap Core portfolio, we own Core Labs. We bought the stock after the stock had taken a pretty considerable price discount. And we like Core Labs because they are more involved in the geological part of E&P companies in analyzing new wells, existing wells, onshore/offshore, where they want to get the most production out of them. They want to reintroduce a well, they go in and they'll do the geology on it to see how much productivity they can get out that well. The E&P companies are very reliant on Core Labs as a value-add -- so they aren't the ones making all the equipment and going in there and spending all this capital equipment and capital spending to go in for the activity. They're more reliant on understanding where the new possibilities are and existing drilling that's already going on. This is a company that despite the fact that the energy sector is going through a very tumultuous time, it still retained about 20% operating margins, and still generating strong free cash flow, despite the fact that it's gone through difficult times.

We like the companies that can sustain high profitability even during those difficult economic times. So we're not going to be overweight energy, but there are certain occasions where we are comfortable going in, such as a Core Lab. Utilities -- we're not going to be in utilities because, capital intensive, regulated by the PUCs on return on equity -- so we're comfortable being completely empty utilities.

So we're not going to force ourselves to invest in a certain sector just because it has a presence in the benchmark. We're not going to change who we are at our high quality bias just to "fill that bucket," so to speak. But again, there are opportunities we find in certain areas where we don't have to sacrifice who we are as investors.

Joe Terranova: *So is it safe to say that you are "agnostic" as it relates to which direction the U.S. dollar trends?*

Jon Christensen: Yes, it kind of goes back to commodity prices for us. In the end, we are looking for how the business is doing – and understanding the fluctuation in the U.S. dollar can go up and down, however you want to predict it – but for us, we really want to look for how the business is doing ex-currency, understanding that there will be those nuances -- but we really want to make sure the business itself is doing well and that's really what's most important to us.

Paul Cahill: *You mentioned earlier this perpetual muddle-along scenario that the U.S. economy is in, can you either handicap or give us your perception of the next phase? Is it pre-recessionary for the U.S., a continuation of more of the same, or any accelerated growth that you see down the road, and what the overall impact relatively speaking would be on your portfolios?*

Jon Christensen: Yes, again, a lot of the prediction of the economy and exactly where the S&P 500 and Dow is going to be, we'll leave that to the so-called, "experts," but here's how I personally view things. I look at things like in a jury trial and the propensity of evidence I see, and right now what we see is an economy where we are in year 6 or 7 of a recovery. We are still in an area where unemployment is low, and the participation rate is at a 39-year low -- which is what I really look at. So I see us in an underemployment type of situation. Wage growth, as we all know, has been very, very muted.

So for me, I see that as being kind of a negative, and then I look at the housing market and see that the market also as one that has recovered in the areas that got hit and hot markets as such as what I'm in Southern California, parts of Florida, Arizona, etc. They're all at peak valuations now. So rising interest rates, in my opinion, can be another headwind. Credit markets still have been very accommodating to people on the upper end of the credit echelon, but on that lower end, people are still having trouble getting credit.

So I look at GDP, which as we know, 70% of GDP is consumer spending. When I look at all things together, that is what's really going to really drive the economy, I just see some headwinds out there, so, for us, again, not trying to make an exact call, I see a continuation of what we've been seeing and then, thus, part of the reason why we're seeing the Fed just continuing the delay in a rate increase.

We continue to see this type of environment. So for us, we're seeing all these things have happened and that's why we think that we're going to be in more of a 1% to 3% GDP environment where it's going to be much more of a stock picker's type of environment, and I think that's where we prosper. Again, you have to look at us over long and multiple economic cycles. It's very difficult to pinpoint a market recovery or a market decline.

But we believe just by investing in great businesses and turning over our portfolio 20% a year -- and that includes, we all have stocks and they're 10 plus years -- we think that just by getting the business right, getting the valuation reasonable over the long term, our companies will succeed and perform well, given the gyrations in the market that we just talked about so that's why when you look at the 23 year track record of Small Cap Core strategy, we've almost got a 5 alpha on this portfolio of .7 data because of the fact that we've been able to, you know, withstand all these ups and downs of the markets and deliver to you long-term consistent returns.

That's been our goal, and that's – again, it comes back to the companies specific that we're talking about. So longer term that's why, you know, I think the next three, you know, year and over, we can make this prediction, but for us, we're making calls on stocks over the next three to five years. Again, I know I sound like a "broken record", but it really is about the long-term track record of these companies. And not trying to cute with market timing which is, I think, is a difficult proposition.

Paul Cahill: *Okay, thank you. If you have any questions about any of the Kayne Anderson Rudnick strategies discussed, whether mutual funds or separately managed accounts, please feel* *free to contact us. You should contact your Virtus regional consultant at 1-800-243-4361 or visit us at www.virtus.com for further information.*

Virtus Small-Cap Core Fund (A: PKSAX, I: PKSFX, R6: VSCRX)
Virtus Small-Cap Sustainable Growth Fund (A: PSGAX, I: PXSGX)
Virtus Quality Small-Cap Fund (A: PQSAX, I: PXQSX)
Virtus Mid-Cap Core Fund (A: VMACX, I: VIMCX)

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