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Episode 35: First Quarter 2016 Review of the Small Cap Core Portfolio

By Jon K. Christensen, CFA
Portfolio Manager & Senior Research Analyst

Hi, I am Jon Christensen, co-Portfolio Manager on the Kayne Anderson Rudnick Small Cap Core Portfolio. Today, I will review our portfolio with a general market overview of the first quarter of 2016, discuss the drivers of performance, talk about new names in the portfolio, and conclude with a market outlook.

The first quarter of 2016 can best be summarized as a roller coaster. In January, the Russell 2000 Index fell almost 9 percent, an ominous start to the New Year and for those who believe in the "as goes January so goes the year" mantra. However, the naysayers may have been pre-mature as February stabilized and was flat while in March the market rebounded—up almost 8 percent—leaving the Russell 2000 down 1.5 percent for the first quarter. This was in comparison to the 1.3 percent positive return for the S&P 500. So, small caps trailed the larger caps overall in the quarter.

The sectors that drove the performance in the quarter were utilities, materials, and producer durables. On the downside, health care was down the most led by biotechs. After seeing several years of gains, the biotechs have been in correction mode since last July. Energy also continued its decline, but some stabilization is emerging.

So what types of businesses did drive the market? Companies with high S&P stock rankings, low betas, and less leverage on their balance sheets all outperformed their counterparts on those metrics. While the quarter did have a high-quality bias, it was not that significant.

Our Small Cap Core Portfolio outperformed the Russell 2000 Index by about 500 basis points in the first quarter. Given the bias to high quality, these results are what you should see from us given our quality philosophy.

We had a few names that drove some of our outperformance for the quarter. Those were MarketAxess, Toro Company, and Graco. We've talked about MarketAxess in the past, so let me go in to a little more detail on Toro and Graco. Toro Company designs and manufactures professional turf and landscape equipment and products. The company had excellent execution this quarter coupled with a better environment for golf rounds played and existing course renovations that have enhanced Toro's recent results. Though with the BOSS acquisition, the company will now have a bigger seasonal exposure to the snow season, historically management has shown that it is adept at managing such a seasonal business. With the good start to the year, guidance for the full year was raised and resulted in the performance of the stock.

Graco designs and makes equipment that pumps, meters, and dispenses various fluids and coatings. Growth in Contractor and the Americas region segments helped Graco outpace expectations in the quarter. Paint store sales saw double-digit growth while home center channel grew in the low-single digits. With little energy exposure, Graco was one of the few industrial companies that did not get caught up in the energy downturn, which in turn led to the company posting 18 consecutive quarters of record same-quarter sales growth. The largest industrial end exposure that Graco does have is non-residential construction and automotive

Stocks that lagged in the quarter were Autohome, Artisan Partners, and Abaxis. We've talked about Autohome in the recent past, so we can give some color on Artisan Partners and Abaxis. Artisan Partners is a multi-strategy investment manager that employs a model whereby teams operate autonomously and share in the economics of their specific strategies. The company has been hurt by net outflows within one of its seven investment teams due to poor performance. Over time, however, we believe the company's business model—built on attracting, developing, and supporting autonomous investment teams—will attract skilled professionals from many potential assets classes and enable overall assets under management to grow.

Abaxis develops blood-analysis systems for use in the veterinarian and human-patient care markets. Abaxis saw its shares fall in the quarter after being a top performer in Q4 2015. The company recently reported revenue declines due to a difficult previous-year comparison as some one-time items bolstered results. Even with the revenue decline, the company saw an increase in its disc sales which have higher margins and led to overall operating margin growth in the quarter versus the previous year.

We had one new purchase in the portfolio along with two sells. Our new purchase was Donaldson Company. Donaldson Company is a manufacturer of filtration systems and replacement parts. The company's products include air filtration systems used in engines, industrial air, gas turbines, and other specialty applications. Donaldson also manufactures liquid filtration systems for hydraulics, fuel, and lube. Typically, the company sells its products directly to OEMs while aftermarket parts are sold through distribution. While Donaldson has to bid and compete on various product platforms of its customers, a platform win offers Donaldson the proprietary position for the life of that product's platform. It also offers the incumbent a slight advantage in the aftermarket filter parts that is a better fit than other replacement alternatives. Aftermarket parts come with higher margins and have been a critical component of the company's ability to improve its operating margins over the past ten years. Aftermarket high margins also offer good margin protection during tough economic times as seen in the depths of the last global recession when margins experienced a trough.

We sold two positions in the quarter. One was CLARCOR, the other one was Sirona Dental. We sold our position in CLARCOR and redeployed the funds to purchase Donaldson, which we believe enhances the overall quality of the portfolio. Both companies operate in similar areas in filtration, but we view Donaldson as having the first mover advantage and placement in the OEM market as defensible competitively. This, combined with the company integrating its largest acquisition in history gave us enough cause to make the switch.

The other company we sold was Sirona. Now Sirona recently completed a merger with Dentsply which created an over ten billion market-cap company, which as you know was too big of a position for us to hold, therefore, we sold our position in recognition of this.

After seeing essentially a "flat" market over the last two years in small caps, we have been experiencing a reversion to high quality as the market continues to have some hurdles to overcome to enhance the sluggish nature of this current "recovery." We believe the reversion to the mean to high quality is appropriate as interest rates seep back up, and the current geo-political environment creates volatility and an unsettling future for global growth rates.

Putting this all together, we believe the market has been adjusting for these factors and that stock picking is more important now than ever. So our contention is that over the long term, you want to own high-quality businesses that have sustainable competitive advantages, outgrow their markets, with low debt and strong free cash flow that trade at discount multiples to the greater market.

Our portfolio continues to look favorable versus the benchmark on these metrics. For example, return on equity for our portfolio is 26 percent at the recent quarter versus 11 percent for the Index; Debt to EBITDA of 1.1 times versus 10 times for that of the Index; Earnings-per-share growth in our portfolio over the last 10 years of almost 11 percent versus 6 percent of the Index. And we are buying these at discounted multiples with a P/E of the trailing twelve months of 21.8 versus 32 for the Index.

This is why we favor our high-quality bias over the long term. That's where we invest. That's our history and our future. Thank you for your time, interest, and continued trust and confidence.