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Episode 36: First Quarter 2016 Review of the Small Cap Quality Value Portfolio

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Hello, this is Craig Stone, Portfolio Manager at Kayne Anderson Rudnick. Today I will be making some brief comments on the first quarter equity market along with some highlights of our Small Cap Quality Value Portfolio.

The equity market in the first quarter was certainly a tale of two halves. During the first six weeks of the quarter, the market saw sharp declines as investors sold off equity shares across the board on worries about China's economy, plunging oil prices, and mixed earnings reports. At the depth of the market decline in February, the S&P 500 Index was off just over 10 percent and the Russell 2000 Index was off nearly 16 percent. At the time, some Wall Street pundits called for the end of the bull market and the beginning of a bear market.

In another example of why timing the market is fraught with missteps and untimely poor decisions, investors who panicked in early February and sold, saw an incredible market recovery as oil prices rebounded, as China's economy's stabilized, and witnessed the global monetary stimulus continue unabated. And by the end of the first quarter, the S&P 500 Index actually ended up plus 1.4 percent while the Russell 2000 Index finished down 1.5 percent. Still a far cry from the depth of February. In fact, it was the largest market recovery in a single quarter since 1933.

We took advantage of the market's volatility and used our long-term perspective to initiate several new positions of high-quality businesses that sold off in January and February due to the overall market conditions.

Our monthly performance in this quarter was truly the best of both worlds. During January, when the market began its sharp sell-off and the Russell 2000 Value Index was down 6.7 percent, we only captured less than 60 percent of the downside—offering tremendous capital preservation. But as the market recovered over the next six weeks of the quarter, we saw our portfolio stocks gain along with the overall market as well. Thus, at the end of the first quarter, our portfolio's performance was substantially ahead of the plus 1.7 [percent] return of the Russell 2000 Value Index. And our performance over the trailing 12 months is even more spectacular with an absolute positive return versus that of the benchmark with a negative 7.7 percent return. Once again, we were able to demonstrate that our investment philosophy of owning high-quality businesses is the right approach.

As I mentioned previously, we initiated two new positions in this quarter. The first is CLARCOR, which is a company that we have owned before but now find the valuation attractive once again. CLARCOR is a manufacturer and distributor of filters for trucks, off-road equipment, gas turbines, and other industrial air-filtration systems. CLARCOR has several exclusive distribution relationships with nationwide trucking companies, railroad lines, and industrial firms. These businesses rely on timely delivery of their products and any delays or failure can result in damages to equipment or violations of environmental standards.

CLARCOR is one of only a few companies that have comprehensive filtration solutions for its customers that are timely, cost effective, and all encompassing. But with the recent pressure on commodity prices, including agricultural and energy prices, CLARCOR has seen its share price decline due to the exposure to those end customers. However, we believe that long term, CLARCOR is one of the premier filtration companies that has weathered through past cycles with solid positioning and high returns on capital, and deserves to trade at a higher valuation.

The other new position is First Financial Bankshares. First Financial operates in the less competitive rural and suburban communities outside major cities in Texas. These smaller markets tend to have more rational competition amongst the local players and are not dominated by larger national banks. First Financial is a decentralized organization with its branch footprint divided into 12 banking regions. Each banking region has its own President and Board. This decentralized structure allows for banking decisions to be made quickly at the local level and results in a high level of customer service tailored to each local community.

Because of these strong customer relationships, First Financial is able to pay low rates for its deposits. Further evidence of the strong affinity its customers have for the bank is the fact that around 15 percent of the company's equity shares outstanding are held by customers within their trust accounts at the bank.

And despite the recent headwinds from low interest rates, First Financial is still generating a 14 percent return on equity, which puts it amongst the best performing banks in the U.S. We used the market weakness, along with general concerns about Texas-based banks and their exposure to energy companies, to initiate a position in this high-quality financial institution. First Financial only has about three percent of its loan portfolio directly tied to energy and given its stellar credit underwriting standards historically, we are not worried.

For those who note that both of our new investments have some ties to energy or energy-related markets; yes this is very observant.

We have always said that we like to look for opportunities in sectors or industries that are under pressure and find companies that are under the similar stock price pressure but not the same fundamental pressure. As we look back over the past year or so, one of the hardest hit sectors is energy. But energy companies, particularly exploration and development or E&P as it is known, do not have an abundance of quality business models. E&P companies are capital intensive, typically outspending its operating cash flow and thus generate negative free cash flow. With negative free cash flow comes the need for external debt or equity capital, resulting in high leverage balance sheets or equity shareholder dilution. These small-cap E&P companies' debt is mostly junk rated, below investment grade, and during this current down cycle, many have declared bankruptcy or needed to raise money just to survive. This is not the definition of high quality.

There are some small-cap energy service companies, providers to the E&P companies but some with technological or business model differentiation that allows for less direct competition, that can be considered quality and we do own a few of them. But even in energy services, high-quality businesses are far and few in between.Thus we try and look for proxies, near energy substitutes or companies, that are suffering through the energy downturn due to business exposure but still fundamentally sound from both business model and from financial characteristics perspectives.

We have used a similar strategy in the past in the financial-services sector, post the global credit crisis in 2008. But regardless of sector or crisis, these companies that we are choosing to invest in still must pass through our high-quality filter first. Valuation alone is not enough for us to invest in a company.

Looking forward, we continue to believe that the risk/reward ratio for equities over the long term is favorable on an absolute basis and particularly relative to fixed income. Equity valuations remain reasonable by historical standards. With favorable corporate cash flow, investors are being rewarded with increased share buybacks, dividends, and occasional acquisitions. Corporate profit margins are still being maintained at very high levels even in a slower growth environment. As consumer confidence stays strong there is a potential for P/E ratio to improve slightly.

In closing, investors should expect more modest equity returns going forward based on the maturity of this business cycle. And in this modest growth economy and maturing economic cycle, we believe high-quality businesses with protected markets are a better place to invest than lower quality companies operating in a more competitive market.

As always, thank you for listening to this recording and we welcome any questions or comments you may have.