Virtus Market Review & Outlook Call with
Kayne Anderson Rudnick CIO Doug Foreman
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Transcript edited for clarity

Barry Mandinach: *Good afternoon, I'm Barry Mandinach, Executive Vice President and Head of Distribution at Virtus Investment Partners, and it's my pleasure to welcome you to our call today. Joining me are Joe Terranova, Virtus' Chief Market Strategist and Doug Foreman from Virtus' Affiliated Manager Kayne Anderson Rudnick Investment Management. Joe, who many of you will recognize as an ensemble member of CNBC's Halftime Report program, is going to moderate today's market review with Doug who is the Chief Investment Officer at Kayne Anderson Rudnick. He has been with the firm since 2011 and also serves as the Portfolio Manager for the Virtus Strategic Growth and the Virtus Mid-Cap Growth Funds.*

Kayne Anderson was established as a family office in 1984 to manage the founder's capital. Today the firm continues to place a priority on wealth preservation while pursuing growth. The portfolio management approach centers on the idea that purchasing high-quality businesses with sustainable competitive advantages at attractive valuations will achieve excess returns over complete market cycle. They seek to achieve these returns meaningfully above those of the benchmark indexes and to do so with portfolios that exhibit lower overall characteristics than the benchmark itself.

At Virtus we're committed to driving better client outcomes, and we believe that insightful market perspective is key to helping investors meet their objectives. With that, it is my pleasure to turn the call over to my friend, Joe Terranova.

Joe Terranova: *Thank you. Doug, I look forward to your comments regarding the current marketplace as it relates to small caps and the overall economic environment. Barry talked about Kayne Anderson being a high-quality manager. Please define the term quality. When we define you as a 'quality' manager, how could we expect that particular style to perform under the many different market cycles that we've gone through?*

Doug Foreman: Quality is probably one of the most overused terms in our business. It's rare to find an investment manager that gets up and says I buy mediocre or low quality businesses at cheap prices and pray that they go up and things get better at some point. So quality is [a term] a lot of investors toss around but at Kayne Anderson Rudnick we're really obsessed with it.

What we mean by quality is a business qualitative characteristic. What we do in our research effort is spend 90% of our time trying to focus on the qualitative aspects of a business. And that means, what's protectable about the business? Is the business profitable? Does it have a sustainable, competitive advantage? What do they do that's different than their competitors because if you're profitable and growing and making a lot of money, there's going to be imitators that are going to attempt to knock you off in the marketplace. So it's our job as investors to ascertain that when the competition comes they're going to be unsuccessful for a variety of reasons in trying to compete away the excess returns that a business is generating. So quality is really a qualitative characteristic; it's not something you can pull out of a spreadsheet or pull out of a screen that you do on the database.

We've learned over the last 20-plus years that there are certain types of businesses that really lend themselves to being protectable, and being sustainable, and being able to grow profitably over the long haul. And there's certain areas like brand franchises. [For example,] WD-40 is a stock that we've owned more than ten years, which has a very powerful brand. That can protect the business.

There are switching costs, which means that a customer is going to have a very difficult time changing vendors if they need to for some reason because [the vendor is] so embedded in the company's infrastructure. There are network effects and scale and cost advantages, and I can go into these in detail but we've learned over the years that these models are something that's sustainable and repeatable. Every time we qualitatively try to look at a business we try to put it into one of these categories to figure out why and what is sustainable about their business that's profitable and growing?

What happens out of this is that it leads to financial statements that have low leverage, high return on equity, low earnings variance, good and free cash flow, low capital intensity, etc. But importantly, unlike most investors, we don't start with the financials and then figure out that these things are going to be sustained. We start with the business itself because we believe that powerful financials flow from the business, not the other way around. Financials don't create a good business. A good business creates great financials over time. So that's what we mean by quality.

In terms of performance, the second part of your question, when should investors expect us to perform? Historically, in flat to down markets or in markets that are low single-digit or mid-single-digit type returns, we usually outperform. The reason is growth is typically in question in the minds of investors, not always in every decline or in every pullback in the market, but a lot of times markets are concerned about the sustainability of growth. When they get worried about growth, they end up finding our companies because our companies typically can grow in both good and bad times — and that's a key part of our research process when we're looking for these businesses. We know that times are good today, but we don't believe anybody can really forecast when times are going to get tough. So a key part of our investment strategy is capital preservation, helping clients navigate through these difficult periods especially in small-cap investing, and making sure that the companies will hold in there and do well during difficult periods as well, so that's really when we shine.

The Russell 2000® Index has been down eight times since 1992 when we started our small-cap core strategy,* which is our longest running strategy at Kayne Anderson Rudnick. The S&P 500® Index has been down four times during that timeframe, and we have only been down twice. When we don't do well is when very bullish, speculative markets take off when growth rates are really picking up across the board and accelerating off the bottom. Typically coming out of a recession, we're going to lag as investors look for companies with more short-term operating leverage then our types of businesses typically possess.

Joe Terranova: *I hear a lot about small caps possibly being less efficient then the large-cap market itself. Is there credibility to that? Do you believe a small-cap market is less efficient than the large-cap market, and if you don't, offer me some evidence why it is it?*

Doug Foreman: I do think it is less efficient overall, simply because there are fewer analysts that focus on small caps on the sell side, so there's less information available to investors. [For example], there's probably 35 analysts following Home Depot closely – and many of them have for many, many years [because] it's a big-cap name. But in small caps, a lot of companies have two or three analysts — typically the investment bank that brought the company public, and maybe another bank that was involved in the original deal.

The types of companies we own — [those with] low leverage, positive cash flow, no debt, not capital intensive — our companies don't need Wall Street for money, period. Since they don't need Wall Street for money, Wall Street doesn't follow them. The only reason that I think most people know is that a Wall Street analyst picks up coverage of a company for the most part in this business is if they can do corporate finance business with the company down the road. And most investment banks make no bones about that. That's the whole reason for the analyst coverage in the first place, is to hope to get a follow-on equity or debt offering. Most of our companies (not every one of them) generate positive cash flows, so they don't need Wall Street, in good or bad times. And so, therefore, our companies are even less well followed.

The other thing that I think is key about the small-cap universe is that a third of the [Russell 2000] Index is typically not profitable and never will be in many cases. So active stock selection in the [small-cap space] has the ability to add some value over time.

Joe Terranova: *You're making a strong argument for what has been in 2016 an investment philosophy conversation about passive versus active, and if you have a marketplace that is less efficient, then clearly an active management strategy may be preferred. The active management strategy supports the belief that it helps the investor participate. Would you agree with that?*

Doug Foreman: Yes, absolutely. Most of the studies that are done about active versus passive [investing] are pretty well focused on the large-cap universe and the large-cap database. Of most of the academic studies done, very few look at other asset classes, whether small-cap, international or emerging markets, or other areas.

Joe Terranova: *Right, I'm asking questions that I might hear on CNBC — the deterrents, the criticism of the small-cap space, the efficiency of active versus passive investing. The other thing that I frequently hear is we're in an extended period of artificially low, private sector borrowing costs. And that clearly has impacted small caps and when rates rise, there may be a problem for the space. Take us through that scenario and how high-quality small caps relative to the overall market would be impacted by the Federal Reserve ultimately at some point moving on rates.*

Doug Foreman: There's no question that low rates have benefited equities overall. But that being said, stocks look attractive to us still, particularly relative to the bond market. It's hard to make the case that stocks are cheap with the S&P 500 making all-time highs. But stocks relative to bonds still look very, very reasonable to us. Investors have to put their money somewhere, and equities overall are probably benefiting from this.

I personally think that stocks with yields have been the primary [beneficiaries] of this yield chase that investors have been embarking upon, particularly over the last six to nine months when coming into the year, people thought the Fed was going to raise rates two to four times, and now most people believe it will be maybe once. So yield chase has been pretty pronounced this year. Most of our companies have little to no yields in the small-cap space that we own. Some of them when they do have a dividend yield, it's 1% or 2%. If you look at performance and do an attribution of what's actually happened this year, the higher the yield, almost the better the performance the stock has had year to date. So we don't feel in our quality universe, that we've benefited disproportionately from this yield chase.

The other thing to point out is that most of the companies that we own our debt-free, so a lower cost of capital really hasn't helped us much either. In a low rate environment, that signals and means there's lower growth going on there, and that clearly has helped us. As I mentioned before, when growth is scarcer and tougher to come by, [investors are] going to find our companies. And that's what's been happening. And so we have benefited from that, but it's not a direct impact I don't think like it has been on the yield-oriented stocks.

Joe Terranova: *A tremendous amount of capital has been flowing into the S&P 500 Index recently. [We often] talk about the need for the investor to have a U.S. orientation, the belief that the U.S., both from an economic capacity and both for its companies earnings powers, clearly stands out on the global stage as being the best-performing economic sovereign. Clearly, when you look at [U.S.] companies, the earnings power is well above the rest of the globe. Could you make an argument that would suggest the investor is diversifying his portfolio by including small-cap holdings with a lot of larger, S&P 500 high-quality exposure?*

Doug Foreman: Yes. As you know, the rage this year and over the last couple of years has been passive investing, particularly in the S&P 500. And given the way that the S&P 500 performed from March of '09, when the market bottomed after the financial collapse, to the middle of '14, it went up in the low 20s on an annualized basis. I think it was about 22-1/2% per annum over that time period, from March of '09 to the middle of '14. So, that's a tough bogie to compete with for anybody, and it was a sensational performance period. It has slowed down a lot since then over the last couple of years. But I would like to point out to people that the S&P 500 doesn't always win. From 2000 to 2010, there was a lost decade that wasn't that long ago, where the S&P 500 was flat to down for basically ten years. If you look at what happened to our small-cap strategy during that same time frame, we compounded at slightly better than 10% a year. Now how did we do that? We did that because the companies we owned were growing at double-digit rates during that time period. So while the S&P 500 has been a great place to be since the market bottomed in early '09, it doesn't always work out that way. We'll see what the future brings. Nobody knows that for certain. But we have a demonstrated history in a long period of ten years where our strategy actually added material value relative to the S&P 500, so I do think there's some diversification. Our companies do march to a little bit of a different drummer. And the companies are plodding along and growing at a low double-digit rate. And that's hugely attractive in pretty much any type of market over the long haul.

Joe Terranova: *We witnessed such a sharp increase in volatility in January and February, and it seems to have set a tone for the year where money managers, investors, pundits, analysts, everyone is fearful that volatility is going to return before the end of the year. I think many would like to say how you start is how you finish. What would your expectation be for the second half of the year as it relates to volatility and the overall financial markets themselves?*

Doug Foreman: It's always tough to forecast a six-month period but we're expecting continued volatility. We've got an election coming up; that can create volatility in and of itself. Certainly after the election is over, there will be more clarity. That can create volatility, particularly in some individual areas, sectors, etc., that would be expected to benefit or to hurt by whomever gets elected. The Fed is obviously on people's radar increasingly. It's sort of been off people's radar for about six months, and I think it's coming back on people's radar now, so that can also create some volatility. So between those two things, it wouldn't surprise me if we have continued whipsawed action from time to time. Equities are volatile — plus or minus 10% moves during the course of a year is very common. It happens, even two or three times a year, even in great markets. It's pretty routine.

So investors have to be long-term oriented and patient and put up with the inevitable volatility that does occur in equities. We think we do a pretty good job of mitigating that. And we've done a great job of preserving people's capital in down markets as I pointed out earlier. We tend to give our clients a much smoother ride than what the overall indices do anyway. And what we'll do in this volatility is we'll simply use it to our advantage as much as possible for our clients by focusing on the individual companies, buying them at the right price, adding to positions if they do get whacked on a Fed increase or an election outcome that's a surprise.

These types of events don't usually end up impacting our companies in any material way over any extended time period. I've been doing this for 30 years. The market is incredibly efficient at matching up the company's growth with the company's stock price return over any reasonable time period. I would encourage people out there and investors that invest with us to stay the course and whatever the market brings short term is anyone's guess, but in the long term, the businesses that we own are doing quite well. We just finished second quarter earnings and for the most part, we're very pleased with what we saw. Our companies are more than on track. We're happy with where we're at, and we think we should be able to generate reasonable returns for people over the long haul as we've done historically.

Joe Terranova: *I'm going to take an opportunity to ask a question that I had wanted to talk about before and that would be the real strong performance in the month of July. We tend to talk about S&P 500 earnings, but could you walk us through what you witnessed in July* for the *Russell 2000 Index? How were the earnings, why such a strong recovery, and was it a response to Brexit?*

Doug Foreman: It's always tough to tell exactly why. In a given month or even a quarterly period, these short-term moves are sometimes difficult for any of us to explain. But I do think obviously risk assets are doing better in the third quarter. The Brexit vote, which clearly was a surprise at least to us and I think most other investors, took the market down briefly. And so we've had some recovery off of that, and we've never believed and still don't believe for one second that the British are going to stop buying BMWs from Germany or wine from France regardless of Brexit or not.

But I do think that what's happened is, if you go back to February which is when the market was very concerned and got off, as you pointed out earlier, to a terrible start to the year — one of the worst in history actually— if you look at what people were worried about back then, they were worried about China melting down, there were worried about two to four Fed rate increases, they were worried about the price of oil collapsing, and they were worried about an imminent global recession. Well, none of those things have happened and second quarter earnings for the most part have come in very well, much better than expected. *The Wall Street Journal* wrote an article about how companies are lowering expectations so they can beat expectations. The whole thing is ridiculous – like somebody is not going to notice that they lowered expectations before they beat expectations? Believe me, the market notices this every single day, and certainly we do and so do others.

Overall though, in a pretty punkish first half, earnings for the most part held together really well, at least in our companies and the things that we monitor. Now granted, we own higher quality businesses that tend to do well in good and bad times, and these aren't terrible times. Growth has been slower than expected for most observers this year, but for the companies themselves, it's been sort of a relief rally where none of the macro mumbo-jumbo that people have been worried about hasn't materialized. The reality is, fundamentals of the businesses are still doing very well, and so you get a nice snapback in prices because of that. That's my guess as to what has happened.

Barry Mandinach: *I want to thank Doug and Joe – we really appreciate your time today. To learn more about Kayne Anderson Rudnick and Virtus' investment solutions, visit virtus.com.*

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