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TOP PERFORMING MANAGERS

Small-cap equity strategies get their mojo back in latest quarter

By Rob Kozlowski

Small-cap strategies led the way for the year ended March 31, with five of the top 10 domestic equity strategies in Morningstar Inc.'s separate account/collective investment trust database.

It was a return to dominance for small cap strategies. For the 12 months ended Dec. 31, they accounted for only two of the top 10 strategies after five straight periods of leading the pack.

Among the top 10 strategies for the year ended March 31, there were three large-cap growth strategies, a midcap growth strategy and a technology strategy. Four of the previous quarter's top 10 domestic equity strategies appeared in this quarter's list.

Among the top-performing managers, both small- and large-cap strategies, "almost all of them have a substantive technology exposure,'' said Tony Thomas, manager research analyst at Morningstar, Chicago, in a telephone interview. "That plays a big role there.''

While the tech sector lost some of its luster in the first quarter, with some struggles at Facebook Inc. and Amazon.com Inc., ''it was still the top-performing sector in the quarter."

Mr. Thomas said small-cap companies, many of which are purely domestic, may have performed better than large-cap multinationals because of fears of a trade war, he said.

"The Russell 2000 lost a fraction in the first quarter, but it did better than the S&P 500," Mr. Thomas said. In the quarter ended March 31, the Russell 2000 index returned -0.08% and the S&P 500 returned -0.76%. The median return for the quarter in the Morningstar universe was -0.6%.

In Morningstar's universe, for the year ended March 31, domestic equity strategies returned a median 13.18%. The Russell 3000 returned 13.81%.

Morningstar's median return for domestic equity growth

OVERALL U.S. EQUITY

		1 year gross return	1 year net return
Kayne Anderson Rudnick SC Quality Select	U.S. SA small growth	76.31%	74.22%
Zevenbergen Genea	U.S. SA technology	51.75%	50.50%
Granahan SC Advantage	U.S. SA small growth	42.40%	41.84%
Kayne Anderson Rudnick SC Sustain Growth	U.S. SA small growth	42.15%	40.78%
Granahan Small Cap Discoveries	U.S. SA small growth	41.34%	40.07%
Granahan Small Cap Focused Growth	U.S. SA small growth	41.25%	40.36%
Morgan Stanley (MS) Multi Cap Growth	U.S. SA large growth	40.26%	38.91%
Advisory Research U.S. Mid Cap Growth	U.S. SA midcap growth	37.95%	36.90%
Marsico Non-Taxable Select Alpha Growth	U.S. SA large growth	37.78%	35.55%
Morgan Stanley Growth	U.S. SA large growth	36.90%	35.94%

Returns as of March 31, 2018. Source: Morningstar.

OVERALL U.S. EQUITY

		5 year gross return	5 year net return
Zevenbergen Genea	U.S. SA technology	27.53%	26.39%
RS Technology Composite	U.S. SA technology	23.16%	21.97%
Wellington Global Technology Opps.	U.S. SA technology	22.40%	21.49%
ZPR Volume Value	U.S. SA financial	22.27%	20.29%
Morgan Stanley Growth	U.S. SA large growth	21.74%	20.85%
MFS Technology Equity	U.S. SA technology	21.61%	
Wellington Global Technology	U.S. SA technology	21.20%	20.31%
Kayne Anderson Rudnick SC Sustain Growth	U.S. SA small growth	20.98%	19.80%
Morgan Stanley Multi Cap Growth	U.S. SA large growth	20.95%	19.77%
Naylor & Co. Core Composite	U.S. SA midcap growth	20.28%	17.77%

Returns as of March 31, 2018. Source: Morningstar.

U.S. STOCK	1 year gross return	1 year net return
Kayne Anderson Rudnick SC Quality Select	76.31	74.30
Zevenbergen Genea	51.75	50.50
BNY Mellon EB DO Large Cap Core	45.19	45.56
Next Century Growth Small Cap Ultra	45.56	44.56
QID U.S. Titans Equity Strategy	43.74	43.74
Maytech Global Growth Composite	43.45	41.94
Granahan SC Advantage	42.40	41.84
Kayne Anderson Rudnick SC Sustain Growth	42.15	40.83
Granahan Inv Mgt - Sm Cap Focused Grth	41.27	40.35
Granahan Inv Mgt Small Cap Discoveries	41.32	40.05

Returns as of March 31, 2018. Source: Morningstar.

U.S. STOCK	5 year gross return	5 year net return
Zevenbergen Genea	27.53	26.39
LEIA CBI	23.14	23.14
AllianzGI Global Technology Equity	23.24	22.10
RS Technology Composite	23.16	21.97
Wellington Global Technology Opps	22.40	21.49
Morgan Stanley (MS) Growth	21.74	20.85
MFS Technology Equity	21.60	20.69
ARI Global Opportunities (ESG)	20.56	20.56
Wellington Global Technology	21.22	20.33
ZPR Volume Value	22.27	20.29

Returns as of March 31, 2018. Source: Morningstar.

strategies for the year ended March 31 was 18.76%, the top-performing category, while the median return for domestic equity value strategies was 9.45%.

Kayne Anderson on top

For the third straight quarter, Kayne Anderson Rudnick Investment Management LLC's Small-Cap Quality Select strategy occupied the No. 1 spot for the year ended March 31 — and again, by a wide margin — with a gross return of 76.31%. The manager also took the fourth overall spot with its Small-Cap Advantage strategy returning a gross 42.15% for the year.

Todd Beiley, portfolio manager and senior research analyst at Kayne Anderson Rudnick, said the aim of the strategies is "really just to find businesses that we can identify (that) have very long-lasting competitive protections."

Both strategies are concentrated, as Mr. Beiley said they try not to overdiversify. He said the advantage strategy tends to have about 30 stocks and the select strategy "is a really more focused version, so that's generally around 10 stocks or so."

"There's overlap in holdings between those two strategies for sure," Mr. Beiley said, "so our results are driven very much by specific holdings, rather than by schematic sectors."

The primary holdings responsible for both strategies' performance are Autohome Inc., a Chinese internet company that offers automotive-related content, and Interactive Brokers Group Inc.

"(Autohome) had been going into a business segment of direct sales, which had put their profitability under pressure," Mr. Beiley said. "New management has since reversed course on that strategy so the profitability of the business has vastly improved over the past year.

"Interactive Brokers, in our view, have a very sound structural advantage as a low-cost operator and they just have persistently gained market share for years and they continue to do so," said Mr. Beiley. "More recently their business has benefited as volatility has come back into the market, (meaning) trading activity has increased, and as short term interest rates have crept up their net interest in income has grown."

Zevenbergen Capital Investments LLC's Genea strategy, a concentrated growth portfolio that looks for companies that are disrupting industries, ranked second on the one-year list, with a gross return of 51.75% for the year ended March 31.

The strategy, which as of April 1 was renamed the Genea strategy, also led the top 10 for the five years ended March 31, with an annualized gross return of 27.53%. It was the third straight quarter the strategy led the five-year list.

Morningstar's Mr. Thomas said much of the success of this manager's strategy has been a significant consumer cyclical stake in technology. He noted that Nancy Zevenbergen, founder, president and chief investment officer of the Seattle-based firm, was an early investor in Starbucks Corp., Microsoft Corp. and other technology companies coming out of the Northwest.

Brooke de Boutray, managing director, portfolio manager at Zevenbergen, said the strategy is a bottom-up, very high-growth, highly concentrated strategy that has about 25 holdings and invests in "disruptive companies that have a very long-term vision that can drive growth for the next decade."

The strategy invests in "high-conviction, founder-led companies that are rather entrepreneurial, I would say, despite their size."

While many of their most recognizable holdings are large-cap companies, "we're just looking for the best growth across all market caps," Ms. de Boutray said. She noted that a lot of high-growth companies in the strategy, such as Amazon.com Inc., Netflix Inc. and Tesla Inc. have grown to become large cap.

Netflix and Amazon have benefited significantly from the growth of e-commerce, Ms. De Boutray said.

"Shopping is really changing. It's going online, there's a lot of disruption in the industry, there's a lot of friction being reduced in the industry, how they're shipped, how we access that," she said.

3 Granahan small-cap strategies

Granahan Investment Management Inc., Waltham, Mass., had three small-cap strategies among the top 10 domestic equity strategies for the year ended March 31: Small Cap Advantage, which ranked third with a gross return of 42.4% for the year; Small Cap Discoveries, which ranked fifth with a gross return of 41.34%; and Small Cap Focused Growth, which ranked sixth with a gross return of 41.25%.

Gary C. Hatton, Granahan's co-founder, chief investment officer and senior managing director, said the Discovery strategy, which he manages, focuses primarily on the "smaller of the small" companies.

"While there are a couple of genuinely microcap companies with capitalizations of between $50 million and $100 million, he said he would describe the strategy primarily as halfway "between the Russell 2000 Growth and the (Russell) Microcap."

The Focused Growth strategy, meanwhile, is managed by Andrew L. Beja, senior vice president and managing director, and has "a singular focus of what (Drew) calls 'desert island' companies, by what he means that if you were on a desert island, if you had to take 40 companies with you," Mr. Hatton said.

Mr. Hatton said Mr. Beja selects holdings based on a methodical calculation of what he believes the returns are going to be for the next 12 to 18 months.

The Advantage strategy, meanwhile, was created three years ago as a way to combine traits of both the Discovery and Focused Growth strategies, Mr. Hatton said.

All the strategies consist of what he calls life cycle diversification, consisting of core growth, pioneer and special situations companies in different weighting. For example, he said in the Discovery strategy, almost all the names he adds begin as pioneer of special situations companies and may graduate into core growth companies.

"An example would be SodaStream (International Ltd.). SodaStream was kind of a broken growth story," Mr. Hatton said. "They weren't doing very well. It would be a special situation when we bought it and it graduates to this core growth category. The beauty of that when that happens, you get the earnings growth part of the story but you also get the valuation growth story."

Five-year leaders

For the five years ended March 31, following Zevenbergen's strategy, the second-ranked strategy was Victory Capital Management Inc.'s RS technology composite strategy, which had an annualized gross return of 23.16%, following by Wellington Management Co. LLP 's Global Technology Opportunity strategy, which returned an annualized gross 22.4%; ZPR Volume Value managed by ZPR Investment Management Inc., 22.27%; and Morgan Stanley (MS) Investment Management's growth strategy, 21.74%. Overall, five of the top 10 strategies for the five years ended March 31 were technology strategies. There were also two large-cap, one midcap and one small-cap strategies, all growth, and one financial sector strategy.

The median annualized return for the five years ended March 31 in the Morningstar universe was 12.57%.

Among collective investment trusts, domestic growth strategies among a variety of small-cap, midcap and large-cap funds accounted for nine of the top strategies for the year ended March 31. The top-performing CIT in that period was T. Rowe Price Group Inc.'s Blue Chip Growth strategy, with a net return of 30.77%.

The rest of the top five CITs for the year ended March 31 were: Wellington Management Co. LLP's CIF II growth strategy, with a net return of 29.7%; T. Rowe Price Group Inc.'s New Horizons strategy, a net 27.05%; MFS Investment Management's growth equity CIT, 26.91%; and Macquarie Asset Management's smidcap growth CIT, 26.63%.

The median net return for domestic collective investment trusts for the year ended March 31 was 12.82%.

For the five years ended March 31, the highest-returning collective investment trust was State Street Global Advisors' Nasdaq-100 index strategy, with an annualized net return of 19.93%, followed by T. Rowe Price's Blue Chip Growth strategy with an annualized net return of 18.38%; Wellington Management's CIF II growth strategy at 17.18%; T. Rowe Price's New Horizons strategy, 17.12%; and T. Rowe Price's growth stock CIT, 17.11%. All multiyear returns are annualized.

The median return for domestic collective investment trusts for the five-year period was 12.45%.

All data for Pensions & Investments' top-performing managers report are provided from Morningstar's global separate account/ collective investment trust database. The data for the rankings on which this story is based were pulled Thursday, April 26.

The Zevenbergen Genea Growth Equity Composite (fka the ZTech Growth Equity Composite) net of fees returns for the period ending March 31, 2018 are as follows: 50.50% for one year, 26.39% for five years. Returns for periods greater than one year are annualized. Returns presented include the reinvestment of any income. Past performance is not indicative of future results.

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