Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

March 31, 2017

Overview

The composite generated a 0.8% return for the first quarter, compared to a 2.5% return for the Russell 2000 Index and a -0.1% return for the Russell 2000 Value Index. Small cap stock prices were mixed in the first quarter. Stocks in sectors considered faster growing, including healthcare and information technology, performed well. Financial stocks, banks in particular, underperformed giving back some of the gains they generated in last year's post-election rally.

The composite underperformed the Russell 2000 Index due in part to lack of exposure to the faster growing sectors that drove much of the index's performance, and outperformed the Russell 2000 Value Index due to a combination of advantageous sector allocation and stock selection.

The risk/reward for equities appears balanced. The outlook for earnings is as favorable as it has been in several years, and if strong growth is achieved, stock prices should respond positively. At the same time, valuations are towards the higher end of their historical range, creating risk to the downside if earnings disappoint.

Market Review

Stocks were mixed in the first quarter, as indicated by the Russell 2000 Index's 2.5% increase, the -0.1% return generated by the Russell 2000 Value Index, and the S&P 500 Index's 6.1% increase. During the first quarter, large cap stocks outperformed small cap stocks, growth stocks outperformed value stocks, and healthcare stocks were among the best performers while financial services stocks underperformed, reversing trends from the fourth quarter of 2016.

The first quarter reversals indicated waning enthusiasm for buying stocks that are expected to be beneficiaries of the new administration's policies. The failure of Congress to repeal the Affordable Care Act called into question the likelihood that policies such as corporate tax reform and bank deregulation would be implemented. For example, small cap stocks pay higher effective tax rates than large cap stocks. Small cap stocks also tend to have less overseas exposure than large cap stocks and were expected to be greater beneficiaries of an acceleration in the U.S. economy brought about by the new administration's policies. Small cap stocks gave back much of their post-election outperformance during the first quarter when investors became less convinced that pro-business policies would be implemented.

The fading "Trump trade" also helps explain the outperformance of growth stocks relative to value stocks. The Russell 2000 Growth Index's 5.4% gain for the quarter included a 2.7% contribution from health care stocks, which rallied when it became clear the Affordable Care Act wouldn't be repealed. For the same period, the Russell 2000 Value Index's -0.1% return included only a 0.4% contribution from the healthcare sector and a -0.8% contribution from financial stocks, which gave back some of their post-election gains.

Portfolio Review

The composite generated a 0.8% return for the first quarter, compared to a 2.5% return for the Russell 2000 Index and a -0.1% return for the Russell 2000 Value Index.

The information technology sector contributed most to the composite's absolute performance during the first quarter due to its large weighting in our clients' portfolios and solid absolute performance. Diebold Nixdorf, Incorporated, a provider of ATMs and related services, contributed positively in response to a solid earnings report and evidence of progress in the integration of the recently acquired Wincor operations.

During the quarter, clients' portfolios holding CEB Inc., a consulting company, announced it was being acquired at a 25% premium to the price it was trading at immediately prior to the announcement.

Our clients' portfolios had a low weighting in the underperforming financials sector relative to the Russell 2000 Value Index and underperforming real estate sector relative to both benchmarks. The low weightings and positive stock selection in these sectors contributed to the composite's return relative to its benchmarks. Realogy Holdings Corp., a residential real estate broker, advanced due to an earnings report highlighted by improving trends in its end markets. Our clients' portfolios' lack of exposure to the poor performing energy sector also contributed positively to the composite's performance relative to its benchmarks.

The consumer discretionary sector detracted most from the composite's absolute performance and was also a significant detractor relative to its benchmarks. Several of our clients' portfolios' retail holdings declined due to the persistent headwinds (weak consumer spending, online competition) facing brick-and-mortar retailers. The healthcare sector also detracted from the composite's performance relative to its benchmarks, particularly the Russell 2000 Index, due primarily to our clients' portfolios' lack of exposure to strong performing biotech stocks which were up 19% during the quarter. Biotech stocks typically do not have earnings and are therefore unsuitable for our investment philosophy.

Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

March 31, 2017

Outlook

The risk/reward for equities appears balanced. Valuations are towards the higher end of their historical range, creating risk to the downside if earnings disappoint. However, the outlook for earnings is favorable, leading to the potential for stock price gains if those expectations are achieved.

Small cap stocks continue to trade towards the high end of their historical valuation range. We believe current valuations are in part a reflection of the low returns available on alternative investments like bonds in a low interest rate environment. However, the Federal Reserve has begun to gradually raise their target interest rate, believing that the economy is healthy enough to withstand a less accommodative monetary policy. If the Fed's move results in meaningfully higher interest rates throughout the economy, equity valuations may not look as attractive relative to bonds.

Current valuations are also supported by an improved outlook for corporate profits. The backdrop is favorable for earnings growth, as indicated by the Fed's confidence that the economy is healthy enough to absorb gradual rate hikes. In addition, economic activity outside the U.S. is expected to accelerate this year after a lackluster 2016. The modest earnings recession experienced by U.S. companies beginning in early 2015 appears to have ended in the second half of last year, providing positive momentum entering this year.

Analysts are expecting first quarter earnings for companies in the S&P 500 Index to grow at their fastest rate since 2011. In addition, analysts expect companies in the Russell 2000 Index to grow earnings 12% in 2017 and the ratio of earning estimate increases to decreases is at its highest level since 2011.

Another component of current valuations is the expectation that earnings will benefit from a more business-friendly administration and Congress. Stock prices will be influenced by the degree of success in implementing corporate tax reform, reduced regulations, and other such policies.

We believe the fundamentals of the companies in our clients' portfolios remain solid and their valuations are attractive relative to the typical small cap company. Because of our focus on finding the best combination of above average earnings growth and below average valuations, our clients' portfolios tend to be somewhat more economically sensitive than their benchmarks. We believe our clients' portfolios are well positioned to take advantage if earnings improve as we expect.

Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

March 31, 2017

William F. Fiedler	Michael Maloney	Mark N. Odegard
Partner, Portfolio Manager	Partner, Portfolio Manager	Partner, Portfolio Manager

Note: Portfolio holdings are subject to change and are not a recommendation to buy individual securities. The views expressed are those of Skyline Asset Management, L.P. and are subject to change. The composite's performance is gross of fees. Gross returns do not reflect the deduction of investment advisory fees or expenses and therefore the client's return will be reduced by the advisory fees and any other expenses it may incur. For example, a separately managed client portfolio, which earned 15% per annum for ten years, would result in a cumulative return of 304.6% before the investment advisory fee of 1% and expenses and 270.7% net of such fees and expenses. The investment advisory fees are described in Part 2 of Skyline's Form ADV.

Sources: Boston Globe Media Partners, LLC; Business Wire, Inc.; Chicago Tribune; CNBC LLC; Credit Suisse Group AG; International Monetary Fund; Jefferies LLC; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.