Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

March 31, 2018

Overview

The composite generated a -1.1% return for the first quarter, compared to a -0.1% return for the Russell 2000 Index and a -2.6% return for the Russell 2000 Value Index. Stock price volatility increased meaningfully, as optimism about earnings early in the period gave way to concerns about higher interest rates and global trade tensions as the quarter unfolded.

The composite underperformed the Russell 2000 Index but outperformed the Russell 2000 Value Index during the first quarter. Strong performance by the fastest growing companies, which make up a greater percentage of the core Russell 2000 Index, helped drive that benchmark's relative outperformance.

The near term outlook for earnings is positive given a favorable global economic backdrop and the expected benefits of corporate tax reform. However, current valuations are at risk to higher interest rates and leave little downside protection against disappointments.

Market Review

Stocks declined during the first quarter, as indicated by returns of -0.1% for the Russell 2000 Index, -2.6% for the Russell 2000 Value Index, and -0.8% for the S&P 500 Index. The first quarter witnessed the return of stock market volatility after several years of relative calm. During the first three months of the year, there were 22 daily market moves of greater than 1% (either up or down) and 6 of greater than 2%, compared to 8 and 0, respectively, for all of 2017.

The spike in equity market volatility came despite a solid outlook for earnings growth and coincided with the release of January U.S. employment statistics. Included in the report was data showing the strongest annual wage growth since 2009. This led to concerns that inflation would accelerate, which in turn contributed to a sharp rise in U.S. Treasury yields. The specter of higher inflation also stoked fears the Federal Reserve would tighten monetary policy faster than expected. The Fed's unprecedented level of monetary easing following the financial crisis was beneficial to asset prices. Investors are now forced to assess the impact policy normalization will have on the economy and asset prices. Towards the end of the quarter, concerns of increased global trade tensions added to investor uncertainty.

Most sectors of the small cap market posted declines in the first quarter. The most notable exceptions were the fastest growing stocks (the Russell 2000 Growth Index rose 2.3% during the period), in particular within the healthcare and information technology sectors. Financial stocks also eked out a small gain. Among the worst performing sectors were real estate and utilities. Stocks in those sectors typically carry relatively high dividend yields, and in periods like the first quarter where interest rates are rising, they become less attractive to income-oriented investors. Energy stocks also underperformed during the quarter due to continued oil price volatility.

Portfolio Review

The composite generated a -1.1% return for the first quarter, compared to a -0.1% return for the Russell 2000 Index and a -2.6% return for the Russell 2000 Value Index. Sector allocation was a positive contributor versus both benchmarks due primarily to our clients' portfolios' modest exposure to poor performing REITs, utilities, and energy stocks. The positive impact of sector allocation was less pronounced versus the core Russell 2000 Index due to the relatively heavy weighting that benchmark has in the strong performing healthcare sector.

Stock selection was a positive contributor relative to the Russell 2000 Value Index but detracted from performance relative to the Russell 2000 Index. Stock selection in the real estate and healthcare sectors contributed positively to the composite's performance relative to both benchmarks, while selection in the consumer discretionary sector was a detractor. The primary difference in the composite's performance relative to each benchmark was within the information technology sector. The modest positive returns generated by our clients' portfolios' tech stocks compared favorably to the loss suffered by tech stocks in the value benchmark, but trailed the solid gains posted by the more growth-oriented tech stocks in the core benchmark.

The healthcare sector contributed most to the composite's absolute performance in the first quarter. The Ensign Group, Inc., an owner and operator of skilled nursing facilities, contributed significantly to the composite's return after reporting solid earnings growth. Ensign is expected to continue to benefit as it strengthens operations at recently acquired facilities. AMN Healthcare Services, Inc., a healthcare staffing company, also contributed positively to the composite's performance, as its leading market share and well-developed systems enable it to take advantage of the ongoing nursing shortage in the U.S.

The industrials sector detracted most from the composite's absolute performance during the first quarter. BMC Stock Holdings, Inc., a distributor of building supplies, declined due to uncertainties created by the departure of its CEO early in the quarter. We believe the business fundamentals are solid and are confident the board will find a suitable replacement.

The real estate sector contributed most to the composite's performance relative to both of its benchmarks due primarily to a lack of exposure to poor performing REITs, which make up the bulk of the sector for the index. Realogy Holdings Corp, a residential real estate broker, rose modestly as its recently appointed CEO laid out his strategy to improve financial results.

The consumer discretionary sector was a detractor to performance relative to both benchmarks. Signet Jewelers Limited, a jewelry retailer, declined after providing disappointing earnings guidance. The factors contributing to the poor guidance caused us to lose confidence in our investment thesis, leading to the sale of the stock during the quarter.

Outlook

Trade tensions have risen recently but we are optimistic they won't escalate to a level that would derail global GDP momentum. Short of an all-out trade war, we believe the outlook for earnings remains constructive as a more favorable regulatory environment and lower corporate taxes are conducive to investment and growth.

In addition, valuations have improved meaningfully with the recent modest decline in stock prices and significant upward revision in earnings estimates (due in part to the benefits of lower corporate tax rates). At the beginning of the year, the Russell 2000 Index was trading at 21.6 times forward 12 month earnings, and has declined to 18.6 times currently. Over the same time frame, our clients' portfolios have seen their forward twelve month P/E fall from 18.1 times to 14.6 times. The decline in valuations has brought them closer to their long term averages after an extended period at the higher end of their historical range.

In our opinion, the recent bout of stock price volatility is a function of financial markets attempting to recalibrate stock valuations. The level of volatility may be heightened because investors have been lulled into a false sense of security following an extended period of calm in the markets. We have observed that changes in sentiment following a steep run up in prices can cause a sharp price decline, followed by a period of elevated volatility, before settling into a more normal trading range.

We don't believe that the elevated level of stock price volatility reflects investor unease about company fundamentals. To the contrary, the most recent quarterly reporting season confirmed the positive outlook for corporate earnings.

As long as fundamentals remain strong, we believe volatility will eventually subside. In the meantime, we would expect to take advantage of price swings to add to stocks that are marked down to more attractive values and trim those that achieve our price objectives.

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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 0.8% and expenses and 277.3% net of such fees and expenses. Current investment advisory fees are described in Part 2 of Skyline's Form ADV.

Sources: Credit Suisse Group AG; Deutsche Bank Securities Inc.; ETF.com; The Nasdaq Stock Market; Politico LLC; Stephens Inc.; SunTrust Robinson Humphrey; The Wall Street Journal; Wells Fargo Securities, LLC; Yardeni Research; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.