Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

March 31, 2019

Overview

The composite generated a 13.0% return for the first quarter, compared to a 14.6% return for the Russell 2000 Index and an 11.9% return for the Russell 2000 Value Index.

Stocks rebounded sharply in the first quarter, partially recovering the steep losses experienced late in 2018. The late 2018 declines were fueled by concerns that the Federal Reserve remained committed to a more restrictive monetary policy despite evidence of a slowing U.S. economy. Stocks rallied sharply after Fed officials indicated they would postpone any further raises in the targeted Federal Funds rate.

Sector allocation negatively impacted the composite's return versus both benchmarks in the first quarter. Stock selection was strong enough to offset negative sector allocation vs. the Russell 2000 Value Index but not the Russell 2000 Index. This is not unusual in a period like the first quarter when growth stocks outperform value stocks.

Earnings are expected to grow this year, albeit at a meaningfully slower rate than 2018's strong pace. However, equity valuations remain at relatively attractive levels, indicating the opportunity for stock price increases if earnings meet their more modest expectations.

Market Review

Stocks advanced during the first quarter, as indicated by returns of 14.6% for the Russell 2000 Index, 11.9% for the Russell 2000 Value Index, and 13.7% for the S&P 500 Index.

The Russell 2000 Index's 14.6% gain in the first quarter was its best start to a year since 1991. The sharp gain in stock prices during the first quarter followed a steep decline late in 2018, when the index fell 27% from August 31st to December 24th, surpassing the 20% decline generally considered the definition of a bear market.

The bear market in small cap stocks in late 2018 reflected investor concerns that the Federal Reserve's more restrictive monetary policy, a slowing global economy, and a potential trade war would contribute to a slowdown in U.S. GDP and corporate earnings. Overseas economies continue to struggle. However, the Fed has paused raising rates and trade negotiations appear to be progressing, easing recessionary concerns. In response, stock prices, which had fallen to attractive valuation levels in late 2018, were bid up by investors during the first quarter.

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Stock price gains were broad-based during the first quarter, with every sector of the Russell 2000 Index posting gains. Growth-oriented sectors like information technology and healthcare were among the best performers. As earnings growth becomes scarcer in a slowing economy, investors tend to bid up those companies they believe can grow regardless of the economic environment. Healthcare stocks also benefitted from increased mergers and acquisition activity in that sector. Real estate stocks also performed well. Interest rates declined, as indicated by the benchmark 10-year U.S. Treasury note's yield falling to 2.4% from 2.7% during the quarter, leading investors to seek yield in high dividend paying stocks like REITs. Energy stocks also responded positively to higher oil prices during the quarter.

Portfolio Review

The composite generated a 13.0% return for the first quarter, compared to a 14.6% return for the Russell 2000 Index and an 11.9% return for the Russell 2000 Value Index. Our clients' portfolios had relatively small weightings in several of the best performing sectors of the market during the first quarter, most notably energy and real estate. In addition, our clients' portfolios had a lower weighting versus the Russell 2000 Index's healthcare sector, which also performed well during the quarter.

The fastest growing stocks, which typically carry higher P/Es, performed well in the first quarter. Due to our valuation discipline, our clients' portfolios lack exposure to those stocks. They are well represented in the Russell 2000 Index, which contributed to the composite's underperformance relative that benchmark. They are a smaller part of the Russell 2000 Value Index, so strong stock selection helped the composite outperform that benchmark.

The industrials sector contributed most to the composite's performance on both an absolute basis and relative to its benchmarks due to its large absolute weighting and solid stock selection. Commercial food service equipment provider Welbilt, Inc., a recent addition to our clients' portfolios, was a significant contributor to the composite's return during the quarter. Welbilt entered the quarter at an extremely attractive valuation and its stock price responded positively when it reported a quarter that largely met investor expectations. We are confident new management will be successful in increasing margins closer to peer levels, and believe the stock remains attractively valued relative to its normalized earnings.

The information technology sector was also a significant contributor to the composite's absolute and relative performance. Versum Materials, Inc., a manufacturer of chemicals used in semiconductor production, rose after receiving a buyout offer well above the price it was trading at just prior to the announcement. The stock was sold as the buyout price exceeded our price target.

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Real estate was the only sector to post a negative return during the quarter, and detracted from the composite's performance relative to its benchmarks. Realogy Holdings Corp., a residential real estate broker, declined due to disappointing results stemming from a weak home transaction environment. We believe higher mortgage rates and low housing inventory, two factors contributing to the slowdown, are temporary in nature and have already begun to correct themselves. The composite also suffered from a lack of exposure to REITs, which performed well as previously discussed.

Outlook

We believe the risk/reward for our clients' portfolios is attractive. Although the economic outlook has dimmed, most economists expect U.S. GDP to grow in 2019, which should provide a positive backdrop for earnings growth. Commentary from company managements indicates that there are pockets of weakness overseas but backlogs and pipelines remain robust in the U.S. We currently expect EPS growth of about 10% for the median company in our clients' portfolios.

Valuations are also attractive, despite the solid gains posted by stocks during the first quarter. The median trailing twelve month P/E of the companies in our clients' portfolios is around 13x, which is towards the lower end of its valuation range. If the economy grows as we expect in 2019, we are optimistic about the near-term outlook for our clients' portfolios. If the economy does fall into a recession, our clients' portfolios might face additional volatility before rebounding. Our confidence stems from our long history of investing over many different stock market environments, including ones similar to the cycle in which we currently find ourselves.

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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: Bloomberg L.P.; Institute for Supply Management; Jefferies LLC; Seeking Alpha; Stephens Inc.; The Wall Street Journal; William Blair & Company; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.