Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

March 31, 2020

Overview

The composite generated a -38.7% return for the first quarter, compared to a -30.6% return for the Russell 2000 Index and a -35.7% return for the Russell 2000 Value Index. Stocks plummeted in response to the fear and uncertainty caused by the COVID-19 pandemic and the impact it would have on the global economy.

The composite underperformed its benchmarks during the quarter. We are extremely disappointed with these results. It is not unusual for our clients' portfolios to experience heightened volatility around turning points in the economic cycle given the nature of the companies that make up its investments. It is a trade-off we are willing to make for what we believe will be superior long-term results. The magnitude of the first quarter sell-off is unsettling, but we believe it is more about the short-term outlook for the economy, panic selling, and forced liquidations by investors and less about the viability and long-term health of our clients' portfolios companies.

The effect the stern social distancing measures governments are taking to stem the spread of COVID-19 is having on economic activity is severe. Investors do not have a precedent to guide them as to the length and severity of the resulting economic downturn or its long-term financial impact.

It is our belief that the companies in our clients' portfolios have the managements, balance sheets, and market positions to survive even a severe contraction in the economy. The massive fiscal stimulus designed to support businesses and individuals will provide some near-term relief. We also believe the pandemic will be contained through the measures currently in place, new treatments, and ultimately, a vaccine. It is also our opinion that, over time, the economy will heal the wounds inflicted on it by the pandemic. Given the extremely attractive valuations the companies in our clients' portfolios are selling at, if we are correct in our assumptions, the outlook for our clients' portfolios over the next three to five years is better than it has ever been with the possible exception of the bottom of the financial crisis in 2009.

Market Review

During the first quarter, the Russell 2000 Index declined 30.6%, the Russell 2000 Value Index declined 35.7%, and the S&P 500 Index fell 19.6%. Stocks plummeted as investors expect the fear and uncertainty created by COVID-19 and the impact of efforts to mitigate it will severely weaken the global economy.

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Signs of economic distress are abundant. Nearly ten million Americans filed new claims for unemployment insurance in the last two weeks of March as large portions of the economy shut down due to social distancing orders. New unemployment claims were averaging about 200,000 per week prior to the recent spike. Business surveys reported sharply falling production, declining new orders, and contracting payrolls. In March, the Consumer Sentiment Index had its fourth largest one month decline in nearly 50 years.

Indicators of investor sentiment also confirmed a flight to safety. The yield on the 10 Year U.S. Treasury note suffered its sharpest quarterly decline since 2011. The CBOE Volatility Index, which measures expectations for stock market volatility, rose 289%, its largest quarterly change ever. During the March 24 week, the Bull/Bear Ratio (BBR) compiled by Investors Intelligence plunged to 0.72 from 3.10 during the first week of the year. The BBR falls below one infrequently and it usually occurs near stock market bottoms.

Among small cap stocks, all sectors posted declines. Economically sensitive sectors such as energy, materials, and consumer discretionary were especially hard hit. Defensive sectors like utilities and consumer staples, and growth sectors such as health care and information technology, declined less than the overall market.

Small cap stocks dropped further than large cap stocks, as indicated by the 30.6% decline posted by the Russell 2000 Index and the 19.6% decline registered by the S&P 500 Index. The first quarter performance extended the trend in place for most of the last three years, which has seen the Russell 2000 Index fall at a 4.6% annual rate and the S&P 500 Index rise 5.1% annually. Large cap stocks are more liquid and their earnings are perceived to be more resilient than small cap stocks, which accounts for their outperformance when investors seek safety.

Growth stocks outperformed value stocks during the first quarter, as indicated by the 25.8% decline for the Russell 2000 Growth Index and the 35.7% decline for the Russell 2000 Value Index. Over the last three years, the small cap growth index is essentially flat, while the small cap value index is down 31.3%. Growth stocks' earnings are expected to hold up better as the economy slows than those of their more economically sensitive value counterparts, contributing to their outperformance when investors become more pessimistic about the economy.

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Portfolio Review

The composite generated a -38.7% return for the first quarter, compared to a -30.6% return for the Russell 2000 Index and a -35.7% return for the Russell 2000 Value Index. Low P/E stocks and economically sensitive stocks were among the worst performers during the quarter.

Skyline's investment process seeks to invest in companies with the best combination of valuation and earnings growth. Companies in sectors considered to have better growth prospects like health care and certain information technology subsectors tend to trade at valuations above what our investment discipline allows. Companies in sectors considered more defensive, like utilities, real estate, and consumer staples, tend not to have the growth characteristics we seek. As a result, Skyline's portfolios are typically heavily invested in sectors more tied to the U.S. economy. This focus on sectors that are more economically sensitive detracted from relative performance during the first quarter.

Another detractor to the composite's relative performance was its focus on low P/E stocks. Low P/E stocks fell much further than high P/E stocks in both the Russell 2000 Index and the Russell 2000 Value Index during the first quarter. Within the Russell 2000 Index, stocks in the lowest two P/E quintiles fell over 40% while those in the highest P/E quintile and those without earnings fell less than 26%. High P/E and non-earners also outperformed low P/E stocks but to a lesser degree within the Russell 2000 Value Index.

One possible reason why a stock may carry a low P/E multiple is that it has more financial leverage and is therefore considered more risky. However, the stocks in our clients' portfolios carry less financial leverage than the relevant small cap indexes. The EBITDA to interest expense ratio, a measure of how much cash flow a company has to service its debts, is 8.6x for our clients' portfolios, well above the 3.4x level of the Russell 2000 Index and the 3.2x for the Russell 2000 Value Index. More importantly, when dialing down a level, every sector of our client's portfolios has a higher EBITDA to interest expense ratio than the corresponding sector of the benchmarks. Even when compared to companies subject to the same macroeconomic factors, the companies in our clients' portfolios have less financial leverage. The lower financial leverage of the companies in our clients' portfolios did not prevent the composite from underperforming its benchmarks.

One additional detractor to the composite's relative performance is its exposure to the consumer in general and employment in particular. We were aware of, and comfortable with, that exposure coming into this year. Unemployment was at historically low levels, the savings rate was healthy, and interest rates were low and credit readily available. The emergence of COVID-19 changed the outlook for the consumer with a rapidity that was unprecedented.

Eight of the largest detractors to the composite were closely tied to the health of the consumer. Only half of those are categorized as consumer discretionary stocks. Three of the largest detractors outside the consumer discretionary sector were housing related. Two industrials stocks, JELD-WEN Holding, Inc. and American Woodmark Corporation, are building products companies serving primarily the residential housing market. We believe the housing market will recover once the worst of the pandemic has passed and these companies will benefit from a solid housing market over the long term. Essent Group Ltd., a provider of private mortgage insurance, declined due to concerns that a spike in unemployment would lead to a rapid increase in mortgage defaults, which in turn would create significant losses for Essent. We believe investors do not properly appreciate the stronger underwriting and capital position Essent is in compared to where private mortgage insurers were during the last housing crisis. In addition, Essent has materially reduced the risk of large losses through the use of reinsurance and financial market transactions.

Every stock in our clients' portfolios declined during the quarter. Those that declined least have businesses that are less influenced by the economic cycle. Examples include health care companies AMN Healthcare Services, Inc., a healthcare staffing firm, and Prestige Consumer Healthcare, Inc., a retail distributor of over-the-counter healthcare and household products. Kemper Corporation, a multiline insurer, declined less than the market. Kemper's largest business, auto insurance, is expected to experience fewer claims as traffic accidents decline due to shelter-in-place orders.

Outlook

During the last three years, investors have favored large cap stocks over small cap stocks, growth stocks over value stocks, and defensive stocks over economically sensitive stocks. The pandemic-fueled plunge in the market during the first quarter accelerated that trend. FTSE Russell calculates a vast array of indexes to isolate market trends. The Russell Top 200 Growth Defensive Index, which is made up of the largest, faster growing, and more defensive stocks, is up 43.4% over the last three years. The Russell 2000 Value Dynamic Index, which consists of smaller, lower valuation, and more economically sensitive stocks, is down 37.3% over the same period of time. This performance differential has left small cap value stocks significantly undervalued relative to other areas of the stock market.

While every economic/stock market cycle is different, a similar performance pattern is found as the market moves from the late phase of a cycle to the early phase of the next cycle. Late in an economic cycle, but before the economy begins to decline, investors sell stocks that are viewed as vulnerable to an economic downturn – smaller, more economically sensitive stocks. When the economic downturn arrives, these stocks drop even further, leaving them extremely undervalued. In cases like 2007-2009 and today, many of these stocks trade at near give-away prices because of widespread fear and loss of confidence among investors. When confidence finally returns to the market, these stocks usually have huge moves off the bottom since they are trading at such low valuations.

As of this writing, uncertainty remains as to the length and severity of the pandemic and its impact on the economy. However, an apparent stabilization of rates of infection in some of the areas hardest hit by the virus appears to have encouraged investors to believe, for now, that the worst case scenario is less likely.

What is certain is that the next several quarters will see a severe decline in the global economy and corporate earnings. However, it is important to recognize that financial markets typically lead changes in the economy. Using the recession of 2007-2008 as an example, the CBOE VIX Index, a measure of stock market volatility expectations, peaked in November 2008. The stock market bottomed four months later in March of 2009. Unemployment didn’t peak until October 2009 and home foreclosures did not peak until September 2010.

The only time over the last 27 years the trailing 12 month P/E of Skyline’s portfolio relative to the S&P 500 Index was lower than it is today was during the internet and technology bubble of the late 1990s. We believe the massive disparity in valuations tips the risk/reward heavily in our clients’ portfolios’ favor.

The trailing P/E does not reflect the impact the pandemic will have on earnings. Given the unprecedented nature of the pandemic, earnings forecasts are subject to a much wider margin of error than usual. With that in mind, the forecasts for the stocks in our clients’ portfolios have been adjusted to reflect a severe economic contraction over the next two quarters, followed by a gradual recovery starting late in the year. On that basis, the median P/E of our clients’ portfolios is 13.5x, a level below its long-term average. We believe the best opportunities for stock price appreciation occur when stocks are trading at low valuations on depressed earnings, a situation we are in today.

The following table lists several of our clients’ portfolios’ holdings and highlights the significant upside potential it holds when the economy regains its footing.

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Name	Sectors	3/31/2020	Normalized EPS	Normalized P/E	Target P/E	Target Price	Upside Potential
BRUNSWICK CORPORPATION	Consumer Discretionary	35.37	4.26	8.3	13.0	55.4	57%
KEMPER CORPORATION	Financials	74.37	6.27	11.9	15.0	94.0	26%
KNOLL, INC.	Industrials	10.32	1.96	5.3	11.0	21.5	109%
REXNORD CORPORATION	Industrials	22.67	1.98	11.4	15.0	29.7	31%
SPX CORPORATION	Industrials	32.64	2.76	11.8	15.0	41.4	27%
WSFS FINANCIAL CORPORATION	Financials	24.92	3.74	6.7	11.0	41.2	65%

We believe the target P/Es are conservative given the solid balance sheets, managements, and market positions of each of these companies. In addition, the normalized EPS reflect levels already achieved by the companies and do not give credit to their strong internal growth prospects.

We remain highly confident that the companies in our clients' portfolios have the managements, balance sheets, and market positions to survive the current crisis. We believe they are selling at a deep discount to their long term earnings potential. The only other time in recent years our clients' portfolios traded at these valuations was at the bottom of the 2008-2009 bear market. That proved to be a great buying opportunity and we believe this one is as well.

William F. Fiedler
Partner, Portfolio Manager

Michael Maloney
Partner, Portfolio Manager

Mark N. Odegard
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 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.; Cable News Network; Coach Investing; FactSet Research Systems Inc.; Jefferies LLC; MKM Partners, LLC; Mortgage News Daily; Security APL; U.S. Bureau of Labor Statistics; The Wall Street Journal; William Blair & Company; Yardeni Research, Inc.; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.