Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

June 30, 2016

Overview

The composite generated a -2.7% return for the second quarter, compared to a 3.8% return for the Russell 2000 Index and a 4.3% return for the Russell 2000 Value Index. For the first six months of 2016, the composite generated a 0.6% return, compared to a 2.2% return for the Russell 2000 Index and a 6.1% return for the Russell 2000 Value Index. Small cap stock prices rose during the first six months of the year, driven in large part by strong performance by higher yielding stocks and a rebound in more commodity-oriented stocks.

Several factors led to the composite's underperformance during the second quarter, including lack of exposure to strong performing REITs, utilities, and commodity-oriented stocks, an overweight in the poor performing consumer discretionary sector, and unfavorable stock selection across several sectors. The composite underperformed both of its benchmarks for the first six months of the year as poor performance during the second quarter more than offset positive results in the first quarter.

Small cap stock valuations remain towards the mid to upper end of their historic range. In addition, earnings growth is harder to come by as the U.S. economic cycle matures and companies face headwinds from weaker overseas economies. However, we continue to find attractive opportunities as many stocks whose fundamentals remain intact have seen their valuations contract meaningfully.

Market Review

Stocks rose in the second quarter, as indicated by the Russell 2000 Index's 3.8% increase, the 4.3% return generated by the Russell 2000 Value Index, and the S&P 500 Index's 2.5% increase. For the first six months of 2016, the Russell 2000 Index rose 2.2%, the Russell 2000 Value Index increased 6.1%, and the S&P 500 Index rose 3.8%.

The stock market went through three distinctive phases during the first six months of the year. Prices declined sharply through early February as investors feared that weakening overseas economies would drag the U.S. economy into a recession. Weak economic data out of China and plunging commodity prices, especially oil, were of particular concern.

However, stocks rebounded strongly from early February until late in the second quarter as several signals emerged indicating the U.S. economy would continue to grow, albeit at a relatively slow pace. For example, The Institute for Supply Management Manufacturing Index, a closely watched gauge of manufacturing activity, rose in both May and June, with June posting the highest reading since February of 2015. U.S. consumer spending rose 1.1% in April, the sharpest rise in almost seven years, and followed with another strong gain in May. Meanwhile, commodities staged strong rallies, highlighted by an 84% increase in the price of oil from its lows in February through quarter end.

Late in the quarter, markets were roiled by Brexit, a referendum by voters in the United Kingdom to exit the European Union. Investors feared a slowdown in economic activity as businesses delayed hiring and new investments due to the uncertainty created by the vote. The Russell 2000 Index declined 7.0% in the two days following the announcement of the voting results, before rebounding 5.8% through quarter end.

Slow global growth and little-to-no inflation have driven investors to seek out investments perceived to be the safest, and the turmoil caused by Brexit reinforced that trend. Shortly after the second quarter ended, the 10 Year U.S. Treasury Note ended the day with a yield below 1.4% for the first time ever. At the end of the quarter, it was estimated that there were $11.7 trillion worth of bonds with negative yields worldwide as investors are more concerned about a return of their principal than the return on that principal.

Except for consumer discretionary, every sector within the small cap market rose during the second quarter. Utilities and REITs stocks were among the best performers as they attracted investors looking for yield in a low interest rate environment. Materials and energy stocks, which were among the worst performers the last two years, posted strong gains during the quarter as commodity prices bounced off of their lows. Consumer discretionary stocks declined as weak earnings at high profile companies like Macy’s and Disney called into question consumers’ willingness to spend.

Year-to-date trends were similar to the second quarter. Utilities, REITs, and materials stocks were among the best performers and consumer discretionary stocks were among the weakest for the reasons mentioned previously. Healthcare stocks were the worst performing sector for the first six months of the year as government inquiries into sharp drug price increases weighed on pharmaceutical and biotech stocks.

Portfolio Review

The composite generated a -2.7% return for the second quarter, compared to a 3.8% return for the Russell 2000 Index and a 4.3% return for the Russell 2000 Value Index. For the first six months of 2016, the composite generated a 0.6% return, compared to a 2.2% return for the Russell 2000 Index and a 6.1% return for the Russell 2000 Value Index. There were several reasons for the underperformance relative to the benchmarks.

First, our clients' portfolios had a lack of exposure to high yielding stocks like REITs, utilities, and commodity-oriented materials and energy companies, which performed quite well during the quarter. Our clients' portfolios are typically underweight in the REITs and utilities sectors, which tend to trade as bond substitutes because of their relatively high dividend yields (i.e. they tend to increase in price when yields fall and vice versa). As interest rates have fallen to historically low levels, valuations of REITs and utilities have soared to valuations we believe are unsustainable, especially given their modest growth prospects. Our clients' portfolios are also typically underweight in energy and commodity-oriented companies because we believe their earnings are driven primarily by difficult-to-predict commodity price movements and not company-specific factors. Our underweight in REITs and utilities on the one hand and energy and commodity-oriented companies on the other hand tend to balance each other out. The former tend to perform relatively well when investors become concerned about the outlook for the economy, while the latter tend to perform best when investors become more optimistic. The second quarter was unusual in that they performed extremely well simultaneously.

In addition, the consumer discretionary sector was a significant detractor to the composite's performance on both an absolute basis and relative to its benchmarks during the second quarter due to its heavy weighting in our clients' portfolios and unfavorable stock selection. Signet Jewelers Limited, a jewelry retailer, declined due to negative reports about the company's business practices and credit operations. We believe the reports are unfounded and Signet remains attractive. We expect earnings will benefit as the integration of the acquired Zale operations drives significant improvement in profitability. Despite the weak second quarter performance, the consumer discretionary sector was a significant contributor to the composite's absolute and relative performance on a year-to-date basis. Drew Industries Incorporated, a provider of components to recreational vehicle and mobile home manufacturers, was a significant contributor to the composite's performance. Drew continues to benefit from its strategy of acquiring smaller component providers and growing their revenues by reaching more customers through Drew's extensive distribution network.

Finally, stock selection was unfavorable across most sectors. However, we believe that for the most part the stocks that performed poorest overreacted to temporary factors and not a significant deterioration in fundamentals. For example, ManpowerGroup Inc., a provider of temporary employment services, Greenhill & Co., Inc., an investment bank, and Korn/Ferry International, an executive search and leadership consulting firm, each declined over 20% in the quarter despite only modest reductions in earnings estimates related to more difficult end-market conditions. We believe the outlooks for these companies remain positive as they continue to execute their strategic plans and they are all selling at attractive valuations.

We believe that the underlying fundamentals of the companies in our clients' portfolios are much stronger than their stock prices would imply. This can occur over short measurement periods like one quarter, especially within the historically volatile small cap value segment of the market. That is why it is important for investors to focus on long term results. Skyline has generated outstanding returns over the long term despite periodic stretches of underperformance. This has been achieved through strict adherence to our investment philosophy. We are committed to maintaining that discipline going forward and expect that investors will be rewarded by their patience.

Outlook

The performance of Skyline's composite relative to its benchmarks during the second quarter of 2016 was its worst since the financial crisis, surpassing the second quarter of 2012 when it underperformed by about 400 basis points. Much like the most recent quarter, stocks were buffeted in the second quarter of 2012 by concerns that a slowdown in China and political turmoil in Europe would drag the U.S. into a recession. Those fears proved to be unfounded and the U.S. economy continued to advance at a slow and steady pace.

Currently, we are further along in the economic recovery than we were in 2012 and there are some worrying signs. In particular, we believe freight demand is one of the best leading indicators of the economy and several trucking firms have recently preannounced disappointing earnings due in part to weak freight demand. However, surveys indicating strong manufacturing activity, non-manufacturing activity, and consumer spending point to continued growth in the U.S. economy.

Small cap stocks as a whole aren't inexpensive. However, many stocks with solid company-specific growth prospects are trading at attractive valuations due to perceived risks related to the overall economy. If we are correct that the perceived risks are overstated and the companies are able to meet their growth expectations, the opportunity for price appreciation remains.

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: Advisor Perspective; C.L. King & Associates; CNBC LLC; Credit Suisse Group; OilPrice.com; Piper Jaffray Companies; Thomson Reuters; Sandler O'Neill + Partners, L.P.; Stephens Inc.; Vox Media, Inc.; The Wall Street Journal; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.