Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

June 30, 2019

Overview

The composite generated a 6.1% return for the second quarter, compared to a 2.1% return for the Russell 2000 Index and a 1.4% return for the Russell 2000 Value Index. For the first six months of 2019, the composite generated a 19.9% return, compared to a 17.0% return for the Russell 2000 Index and a 13.5% return for the Russell 2000 Value Index.

Stocks rose during the second quarter and year to date despite evidence the U.S. economy is decelerating. Investors appeared to believe a recession was less likely following comments by the Federal Reserve indicating a shift from a restrictive monetary policy to a more accommodative one. A corresponding sharp drop in interest rates increased the attractiveness of stocks compared to bonds.

The composite outperformed both of its benchmarks for both the second quarter and first six months of the year. Stock selection was a positive contributor over both periods, while sector allocation was positive during the second quarter but detracted on a year-to-date basis.

In recent years, large cap stocks have meaningfully outperformed small cap stocks and growth stocks have meaningfully outperformed value stocks, leading to the most attractive relative valuations for small cap value stocks in several years. As a result, we are optimistic about the opportunity for our clients' portfolios if earnings meet their more modest expectations.

Market Review

Stocks advanced during the second quarter, as indicated by returns of 2.1% for the Russell 2000 Index, 1.4% for the Russell 2000 Value Index, and 4.3% for the S&P 500 Index. The second quarter gains followed up on strong first quarter results, leading to year-to-date gains of 17.0% for the Russell 2000 Index, 13.5% for the Russell 2000 Value Index, and 18.5% for the S&P 500 Index.

The current stock rally began when the Federal Reserve announced a pause in increasing its target for the Federal Funds rate and was sustained by further commentary indicating they were prepared to cut rates, if necessary, to sustain the economic expansion. This encouraged investors to view the evident deceleration in the U.S. economy as temporary and not an indication that a recession was imminent.

Another factor supporting stocks this year is the decline in interest rates, which have made bonds less attractive relative to stocks. The yield on the benchmark U.S. 10 Year Treasury Note peaked at 2.78% early in the year before declining to 2.01% at the end of the second quarter. As yields on bonds decline, those provided by stocks become more attractive, all else being equal.

The rise in stock prices this year has come despite a diminishing outlook for corporate earnings. Slowing overseas economies and uncertainties resulting from increasing global trade tensions have caused company managements to become more cautious. The Institute for Supply Management Manufacturing Index, a good gauge of the U.S. industrial economy, fell in June to a nine-year low. This in turn has caused earnings estimates to be cut. Analysts entered the year expecting small cap earnings per share to grow double digits but are now expecting them to be essentially unchanged.

Trends were mixed during the second quarter from a sector performance standpoint. Industrials stocks were the best performers despite signs of a slowing industrial economy. Utilities also performed well, as one might expect when interest rates fall and investors look to higher yielding sectors like utilities. However, real estate stocks, which also tend to be higher-yielding, were not standout performers during the quarter.

Almost every sector in the small cap market was up for the first six months of the year, but trends were also mixed. Economically sensitive sectors such as industrials performed well, but so did more defensive sectors like REITs and utilities. Among the sectors considered to have the best growth prospects, information technology stocks were strong performers, while healthcare stocks trailed the index.

During the quarter, large cap stocks continued their extended run of outperformance relative to small cap stocks, as indicated by the table below.

	Q2 2019	YTD 2019	1 Year	3 Year CGR	5 Year CGR
S&P 500 Index	4.30	18.54	10.42	14.19	10.71
Russell 2000 Index	2.10	16.98	(3.31)	12.30	7.06

The S&P 500 Index ended the second quarter near its all-time high, while the Russell 2000 Index remained 10% below its all-time high.

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One contributor to the recent outperformance of large cap stocks was their attractive valuations relative to small cap stocks at the beginning of the run. That outperformance has eliminated that valuation advantage, and currently small cap stocks now look relatively inexpensive compared to their larger counterparts. By some measures, the premium being paid by investors for large stocks is at its highest level since the technology bubble 20 years ago.

More recently, large cap outperformance has been supported by more resilient earnings. While earnings estimates for most stocks have declined this year, they have fallen more sharply for small cap stocks than large cap stocks. Although both segments of the market have seen their sales outlooks diminish, small cap stocks are expected to experience greater margin compression. This is likely due to large cap stocks' ability to manage the cost pressures facing most companies.

Small cap growth stocks continued their extended period of outperformance relative to small cap value stocks in the most recent quarter, as highlighted in the table below.

	Q2 2019	YTD 2019	1 Year	3 Year CGR	5 Year CGR
Russell 2000 Growth Index	2.75	20.36	(0.49)	14.69	8.63
Russell 2000 Value Index	1.37	13.47	(6.24)	9.81	5.39

As investors become more concerned about the economic environment, they tend to favor stocks they believe will be able grow their earnings throughout the economic cycle. Because of growth's extended outperformance, on some measures, small cap value stocks are at their most attractive relative valuations since 2001.

Portfolio Review

The composite generated a 6.1% return for the second quarter, compared to a 2.1% return for the Russell 2000 Index and a 1.4% return for the Russell 2000 Value Index. For the first six months of the year, the composite was up 19.9%, compared to 17.0% for the Russell 2000 Index and 13.5% for the Russell 2000 Value Index.

Strong stock selection contributed to the composite's outperformance for the second quarter and year to date, despite facing two major headwinds. First, growth stocks outperformed value stocks, as previously mentioned. Due to our valuation discipline, our clients' portfolios lack exposure to the fastest growing stocks. In addition, higher yielding stocks, like utilities (especially in the second quarter) and REITs (year to date), outperformed. Those stocks are typically owned for their dividend yields and tend not to have the growth prospects we seek. In addition, their P/Es are near historical highs, making them less attractive to us.

The industrials sector contributed most to the composite's performance on an absolute basis for both the second quarter and first six months of the year due to strong stock performance and the sector's heavy weight within our clients' portfolios. Columbus McKinnon Corporation, a hoist manufacturer, was a significant contributor over both periods. The company continues to outperform our expectations. A new CEO, Mark Morelli, has restructured operations, which have significantly expanded operating margins and earnings despite lackluster end markets.

The consumer discretionary sector was an important contributor to the composite's performance relative to its benchmarks for the second quarter and first six months of the year. Aaron's, Inc., a lease-to-own retailer of home goods, was a major contributor over both time frames. The company delivered solid earnings driven primarily by rapid growth in its Progressive subsidiary, which provides lease-to-own financing to third-party retailers.

The real estate sector detracted most from the composite's absolute performance for both the second quarter and year to date. It also detracted from the composite's return relative to its benchmarks. Realogy Holdings Corp., a residential real estate broker, declined as a slower housing market and increased competition led to reduced earnings expectations. After reassessing the competitive environment and its impact on the company, the stock was sold.

Outlook

We believe the risk/reward for our clients' portfolios is attractive. The relative valuation of small cap value stocks is the best it has been in quite some time given their extended period of underperformance compared to large stocks and growth stocks. Despite the strong performance of the composite year to date, the median trailing P/E of its stocks is around 14x, which we believe provides some downside protection, especially considering the returns available on other investment options.

We currently expect the companies in our clients' portfolios to generate EPS growth of about 8% this year. This rate of growth is down from where we expected entering this year, a reflection of the uncertainty caused by a slowing global economy and increasing trade tensions. If our earnings expectations our met, we would expect our stocks to react favorably. Given current valuations, we believe the outlook over the next several years is positive, even if earnings disappoint in the near term.

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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.; CJS Securities, Inc.; Jefferies LLC; Keefe, Bruyette & Woods, Inc.; Raymond James Financial, Inc.; The Wall Street Journal; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.