Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

June 30, 2020

Overview

The composite generated a 26.4% return for the second quarter, compared to a 25.4% return for the Russell 2000 Index and an 18.9% return for the Russell 2000 Value Index. For the first six months of 2020, the composite generated a -22.6% return, compared to a -13.0% return for the Russell 2000 Index and a -23.5% return for the Russell 2000 Value Index. Stocks rebounded sharply during the second quarter, recouping some of the losses they suffered earlier in the year. Although a great deal remains unknown about the impact of the COVID-19 pandemic on the global economy, the most dire scenarios envisioned during the peak of uncertainty no longer seem likely.

The composite performed in line with the Russell 2000 Index and outperformed the Russell 2000 Value Index during the second quarter. Although stock selection was positive versus both benchmarks, sector allocation detracted from the composite's performance relative to the core Russell 2000 Index, but contributed to the relative performance versus the value-oriented Russell 2000 Value Index. Year to date, the composite underperformed the Russell 2000 Index, which benefited from relatively high exposure to growth stocks, which have outperformed value stocks so far this year. The composite outperformed the Russell 2000 Value Index due to advantageous sector allocation over the first six months of the year.

We believe the economy and corporate earnings bottomed in the recently completed second quarter. The pace and sustainability of the recovery depends on many factors, the most important of which is progress in mitigating the impact of the pandemic. It is our belief that the companies in our clients' portfolios have the managements, balance sheets, and market positions to survive in this difficult environment and we expect them to thrive as the economy improves. Despite the strong rebound in stock prices during the second quarter, the valuations of our clients' portfolios' holdings remain attractive based upon their earnings in a more normal economic environment, particularly when compared to the stock market as a whole and to other investment alternatives.

Market Review

During the second quarter, the Russell 2000 Index rose 25.4%, the Russell 2000 Value Index rose 18.9%, and the S&P 500 Index rose 20.5%. The S&P 500 Index's quarterly gain was the largest in over 20 years, while the Russell 2000 Index's gain was the largest in almost 30 years. Stocks rebounded as investor panic subsided from its heightened first quarter levels.

Uncertainty remains regarding how severely COVID-19 and the efforts to mitigate it will impact the global economy. However, the worst case scenarios contemplated by investors late in the first quarter no longer appear likely. For example, economists were expecting May U.S. unemployment to reach 20%, but the official rate reported was 13.3%. Retail sales also rose at a record pace in

May, far exceeding estimates. As well, measures of U.S. manufacturing and services sectors activity saw steady improvement throughout the quarter.

Among small cap stocks, sector performance reflected an economic environment that was better than feared. Economically sensitive sectors such as energy, materials, and consumer discretionary exhibited some of the sharpest rebounds. Defensive sectors like utilities and real estate were among the weaker performers. Health care stocks continued their strong relative performance, driven in large part by biotech stocks. Financials stocks lagged, as the combination of higher loan losses and lower interest rates weighed on bank valuations.

For the first six months of 2020, the Russell 2000 fell 13.0%, the Russell 2000 Value Index fell 23.5%, and the S&P 500 Index fell 3.1%. The strong second quarter rebound was not enough to offset steep first quarter declines, especially among small cap stocks and small cap value stocks in particular.

Health care was the only sector posting positive results in the Russell 2000 Index on a year-to-date basis, and information technology stocks performed relatively well, reflecting investor preference for growth oriented stocks. Due to the plunge in oil prices, the energy sector was the worst performer year to date. Financials stocks were also poor relative performers for reasons stated earlier.

Despite their second quarter outperformance, small cap stocks have underperformed year to date, as indicated by the 13.0% decline posted by the Russell 2000 Index and the 3.1% decline registered by the S&P 500 Index. The first half performance extended the trend in place for most of the last three years, which has seen the Russell 2000 Index rise at a 2.0% annual rate and the S&P 500 Index rise 10.7% annually.

Growth stocks outperformed value stocks for the first six months of the year, as indicated by the 3.1% decline for the Russell 2000 Growth Index and the 23.5% decline for the Russell 2000 Value Index. Over the last three years, the small cap growth index has increased 7.9% annually, while the small cap value index has declined at a 4.4% annual rate. 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.

One would have expected value stocks to outperform growth stocks during the second quarter when investors were becoming less pessimistic about the economy, but that was not the case. Although the more cyclical sectors did perform quite well during the quarter, this was offset by the heavy weighting of the poor performing financials, real estate, and utilities sectors in the value index. At the same time, the growth index benefitted from the heavy representation of the outperforming heath care sector.

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Portfolio Review

The composite generated a 26.4% return for the second quarter, compared to a 25.4% return for the Russell 2000 Index and an 18.9% return for the Russell 2000 Value Index. Stock gains were broad based and the composite participated in the gains.

The industrials sector contributed most to the composite's absolute performance during the second quarter and was a major contributor to its performance relative to its benchmarks as well. Industrials stocks are tied closely to the global economy and rebounded strongly during the second quarter as investors became less pessimistic about the economic outlook.

Several of our clients' portfolios' building products companies, including BMC Stock Holdings, Inc., JELD-WEN Holding, Inc., and American Woodmark Corporation, were among the top contributors to the composite's performance during the quarter. Signs of a rebound in the housing market benefited building products companies. In addition, surveys show that consumers expect to spend more money on home improvements in response to spending a greater amount of time at home due to the coronavirus.

The health care sector detracted most from the composite's absolute and relative performance during the second quarter. Varex Imaging Corporation, a manufacturer of x-ray components, was the largest detractor to the composite's performance. Although the company is seeing strong COVID-19 related revenues, it was more than offset by a decline in demand for products used in elective medical procedures, cargo screening, and oil exploration. We believe Varex remains well positioned in its markets and has the potential for significant margin enhancement as demand improves.

For the first six months of 2020, the composite generated a -22.6% return, compared to a -13.0% return for the Russell 2000 Index and a -23.5% return for the Russell 2000 Value Index.

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 and the rebound in the second quarter was not enough to offset those losses.

The consumer discretionary sector posted the smallest year-to-date decline of any sector of our clients' portfolios. Winnebago Industries, Inc. and LCI Industries were among the handful of stocks in our clients' portfolios that posted stock price gains for the first six months of 2020. Both serve the recreational vehicle market. Demand for RVs has increased, as they provide an attractive alternative to families wishing to vacation but reluctant to fly or stay at hotels due to coronavirus-related concerns. Brunswick Corporation, a supplier of recreational products, also posted a gain for the first half of the year. Demand for Brunswick's marine related products are strong, as boating is seen as one of the few recreational activities consistent with social-distancing guidelines.

Financials stocks detracted most from the composite's absolute performance for the first six months of the year. Bank stock prices suffered due to the concerns that loan losses would increase meaningfully as many businesses fail to recover from the impact of coronavirus-related shutdowns. In addition, record low interest rates are expected to have a negative impact on banks' net interest margins. Hancock Whitney Corporation, a Gulfport, MS based commercial bank, was one of the biggest detractors to the composite's performance year to date. In addition to the issues facing all banks, Hancock's exposure to the troubled energy sector is higher than its peers.

Outlook

Conducting an internet search for the phrase "disconnect between economy and stock market" generated 5.8 million results. The powerful rebound in stock prices during the second quarter pushed the technology-heavy NASDAQ Index to all-time highs, while the S&P 500 Index ended the quarter within 10% of its all-time high. This occurred as the global economy faced its worse contraction since the great depression. This apparent contradiction has been interpreted by the financial press as evidence that investors are optimistic that the economy will fully recover in relatively short order.

We interpret the data differently. The large cap indexes are dominated by a handful of companies - Alphabet (the parent of Google), Amazon, Apple, Facebook, and Microsoft – which make up 23% of the S&P 500 Index and 36% of the NASDAQ Composite. These stocks are among the biggest beneficiaries of the economic upheaval caused by the coronavirus. In our opinion, their advantages will be less pronounced after the crisis is over as most consumers revert to their pre-pandemic way of life. These stocks are trading at or near their all-time highs. They have seen their stock prices increase 285% over the last five years and trade at 40x forward earnings on average.

In contrast, the Russell 2000 Value Index of small cap value stocks is down 1.3% over the last 5 years, remaining nearly 30% below its all-time high recorded in August of 2018 and trades at 16.5x forward earnings. Because of the size and sector representation of the companies that make up the index, the Russell 2000 Value Index tends to be the most directly impacted by changes in the economic outlook. Its poor absolute and relative performance over the last several years and its relative low valuation, especially when considering earnings are currently depressed, indicate to us that investors prefer stocks that benefit from the current environment and are not overly optimistic about a rebound in the economy.

The only period when the P/E of Skyline's portfolios have been lower relative to the S&P 500 Index was during the growth stock and internet bubble of the late 1990s. In addition, small cap value stocks tend to have greater earnings growth potential coming out of a recession. In our opinion, once this growth occurs, the wide gap in P/E multiples between large growth stocks and small value stocks will narrow, leading to big outperformance by small cap value stocks.

We believe the stocks in our clients' portfolios provide even greater upside than the average small cap value stock. We remain highly confident they have the managements, balance sheets, and market positions to survive the current crisis. In our opinion, they are selling at a deep discount to their long-term earnings potential despite the strong price gains posted in second quarter. On average, they are trading at 12x their pre-pandemic earnings levels. Their solid company-specific earnings growth drivers give us confidence that as the economy improves, they will return to and eventually exceed pre-pandemic earnings levels. This underpins the confidence we have in the long-term outlook for our clients' portfolios.

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 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: The Associated Press; Bloomberg L.P.; CL King & Associates, Inc.; CNBC LLC; D.A. Davidson & Co.; Forbes Media LLC; Google LLC; Jefferies LLC; JPMorgan Chase & Co.; The New York Times Company; Trading Economics; The Wall Street Journal; Yardeni Research, Inc.; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.