Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

September 30, 2017

Overview

The composite generated a 6.0% return for the third quarter, compared to a 5.7% return for the Russell 2000 Index and a 5.1% return for the Russell 2000 Value Index. For the first nine months of the year, the composite increased 8.4%, while the Russell 2000 Index rose 10.9% and the Russell 2000 Value Index increased 5.7%. Stocks rose broadly during the third quarter, as all sectors with meaningful weights in the indexes posted gains. For the first nine months of the year, most sectors rose with energy being a notable exception.

During the third quarter, the composite outperformed the Russell 2000 Index due to favorable stock selection and the Russell 2000 Value Index due to the positive contribution of both sector allocation and stock selection. For the first nine months of the year, the composite underperformed the Russell 2000 Index due primarily to a lack of exposure to the high growth/high valuation stocks that drove much of the index's performance in the first half of the year. The composite outperformed the Russell 2000 Value Index for the first nine months of the year due to advantageous sector allocation and stock selection.

Stock prices continue to benefit from a solid outlook for earnings and low interest rates. However, investors have bid up stocks in anticipation of the enactment of meaningful tax reform that is expected to be beneficial to corporations' bottom lines. Stock prices going forward will be influenced by the relative success or failure of corporate tax reform.

Market Review

Stocks rose during the third quarter, as indicated by the Russell 2000 Index's 5.7% increase, the 5.1% return generated by the Russell 2000 Value Index, the 6.2% increase for the Russell 2000 Growth Index, and the S&P 500 Index's 4.5% increase. The strong third quarter performance helped drive year-to-date gains of 10.9% for the Russell 2000 Index, 5.7% for the Russell 2000 Value Index, 16.8% for the Russell 2000 Growth Index, and 14.2% for the S&P 500 Index. All four indexes ended the quarter at all-time highs.

Despite the wide differential in year-to-date performance between small cap growth, small cap value, and large cap stocks, performance over the last year is more closely aligned, with the Russell 2000 Index up 20.7%, the Russell 2000 Value Index up 20.6%, the Russell 2000 Growth Index up 21.0%, and the S&P 500 Index up 18.6%. Over the same time frame, the composite is up 24.8%. In late 2016, the "Trump Trade" drove strong relative performance by small cap and value-oriented companies due to expectations they would benefit disproportionately from a more business-friendly and lower corporate tax rate environment. For most of 2017, expectations that the new administration's programs would be implemented diminished, causing a reversal away from small and value-oriented companies towards large cap and growth companies. However, late in the third quarter of 2017, Republicans released the outlines of their proposed tax reforms, and the Trump Trade was rekindled.

Stock price gains were fairly broad-based during the third quarter and year to date, with most sectors generating positive returns. Healthcare stocks performed particularly well driven by biotech stocks, which rebounded from a weak 2016 as the controversy over drug pricing became less prominent in investors' minds. Economically sensitive sectors like industrials and materials also performed well in response to an improved outlook for the global economy. Although energy stocks rebounded in the third quarter along with oil prices, the gains were not enough to offset declines earlier in the year.

Portfolio Review

The composite generated a 6.0% return for the third quarter, compared to a 5.7% return for the Russell 2000 Index and a 5.1% return for the Russell 2000 Value Index. Year to date, the composite is up 8.4%, versus 10.9% for the Russell 2000 Index and 5.7% for the Russell 2000 Value Index. Our clients' portfolios are constructed to own stocks with the best combination of value and earnings growth. Therefore, they do not own the fastest growing small cap stocks (which typically carry high P/Es) that make up a portion of the core Russell 2000 Index. When growth stocks significantly outperform, as they have so far in 2017, performing well relative to the core index is challenging. At the same time, because we do incorporate a growth component into our investment philosophy, the composite tends to perform better than the value benchmark when growth stocks outperform.

The composite outperformed both of its benchmarks during the third quarter due in part to strong performance by its industrials and consumer discretionary sectors. Columbus McKinnon Corporation (CMCO), a global manufacturer of materials handling systems and services, was the largest contributor to the composite's performance during the quarter. CMCO reported earnings that were much better than street expectations. In addition to benefiting from an increase in domestic demand, CMCO is benefiting from cost reductions and the contributions from recent acquisitions. The Children's Place, Inc. (PLCE), a children's clothing retailer, was also a significant contributor to the composite's performance during the quarter. PLCE continues to deliver better than expected earnings results in a difficult retail environment due to steps taken by management to improve merchandising and operate more efficiently. PLCE is also benefitting from the financial and operational struggles at some of its largest competitors.

The financials sector was a major detractor from the composite's performance relative to its benchmarks during the third quarter. Greenhill & Co., Inc., an independent investment banking firm, reported disappointing results due to a slowdown in completed transactions. Despite the slowdown, the pipeline appears solid and management announced a large share repurchase and significant insider buying.

The composite performed well on an absolute basis for the first nine months of the year. Ferro Corporation, a specialty chemical producer, contributed most to the composite's performance for the first nine months of the year. Ferro is benefiting from the repositioning of its product portfolio towards higher-margin specialty products, which is driving better than expected revenue and earnings growth. ManpowerGroup Inc., an employment services company, was a major contributor to the composite's year-to-date results. Manpower is benefitting from the economic recovery in Europe and improved margins resulting from recent restructuring actions.

The strong year-to-date absolute return was somewhat negatively impacted by performance at several of our retail holdings. Given the headwinds facing traditional brick-and-mortar retailers, we have reduced our exposure there to only our highest conviction holdings.

The composite underperformed the Russell 2000 Index for the first nine months of the year. The largest detractor to relative performance was the relatively low weighting in healthcare stocks, particularly the fast growing (and highly valued) biotech subsector. Absolute performance in the sector was solid, led by Teleflex Incorporated, a medical devices company. Teleflex announced an attractive acquisition and is expected to continue to benefit from efforts to drive margin expansion through increasing operating leverage.

The composite outperformed the Russell 2000 Value Index for the first nine months of the year due to advantageous sector allocation, highlighted by its lack of exposure to the poor performing energy sector, and solid stock selection.

Outlook

The fundamental backdrop for earnings growth is positive. The global economy is experiencing its most synchronized expansion since the 2008/2009 recession. U.S. GDP grew 3% in the second quarter, the fastest pace since the first quarter of 2015, and is expected to accelerate further in the third quarter. The current U.S. administration is committed to reducing the impact of regulations on businesses and there continues to be momentum building towards comprehensive tax reform, including a meaningful reduction in the U.S. corporate tax rate.

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In light of the positive outlook for earnings, small cap stocks continue to trade towards the high end of their historical valuation range. We believe current valuations are also a reflection of the low returns available on alternative investments like bonds in a low interest rate environment. We believe it is critical for companies to deliver their expected earnings, as there is little valuation support for disappointments. Valuations may also reflect expectations that tax reform will be enacted, so failure to do so may negatively impact prices.

We believe the fundamentals of the companies in our clients' portfolios remain solid and their valuations are attractive relative to the typical small cap company. Because of our focus on finding the best combination of above average earnings growth and below average valuations, our clients' portfolios tend to be somewhat more economically sensitive than their benchmarks. We believe our client's portfolios are well positioned to take advantage if earnings improve as we expect.

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.; MarketWatch, Inc.; Morgan Stanley & Co. LLC; Nasdaq Stock Market; Northcoast Research Holdings, LLC; Sandler O'Neill + Partners, L.P.; Seaport Global Securities LLC; Stephens Inc.; The Wall Street Journal; The Washington Post; William Blair & Company, L.L.C.; Yardeni Research; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.