Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

September 30, 2018

Overview

The composite generated a 0.3% return for the third quarter, compared to a 3.6% return for the Russell 2000 Index and a 1.6% return for the Russell 2000 Value Index. For the first nine months of the year, the composite generated a 2.9% return, versus an 11.5% return for the Russell 2000 Index and 7.1% return for the Russell 2000 Value Index.

Small cap stocks rose modestly in the third quarter. Companies reported strong earnings results, helped by a strong U.S. economy and corporate tax reform. Stock price gains were more muted, as the earnings results appeared to already be reflected in stock valuations. Concerns about the negative fallout from a global trade war also weighed on stock prices. The third quarter results built on gains generated earlier in the year, leading to solid year-to-date results.

The composite underperformed both of its primary benchmarks for both the third quarter and first nine months of the year. Stocks with the highest P/Es and those with negative earnings significantly outperformed lower P/E stocks, making it a difficult environment for our style of investing. A relatively large weighting in the poor performing building products sub-sector also hurt performance over both time frames.

The near term outlook for earnings is positive given a favorable U.S. economic backdrop and the expected benefits of corporate tax reform. Valuations have improved from their recent highs. However, they remain at levels that provide little downside protection if earnings growth disappoints.

Market Review

Stocks rose during the third quarter, as indicated by returns of 3.6% for the Russell 2000 Index, 1.6% for the Russell 2000 Value Index, and 7.7% for the S&P 500 Index. For the first nine months of the year, the Russell 2000 Index generated an 11.5% return, the Russell 2000 Value Index rose 7.1%, and the S&P 500 Index returned 10.6%.

A strong backdrop for corporate earnings, including solid U.S. GDP growth and lower corporate taxes, helped drive stock price gains for both the third quarter and first nine months of the year. Companies reported second quarter EPS growth of greater than 20%, and are expected to post similar results for the third quarter and all of 2018 as well.

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Stock price gains in the quarter and year to date were more modest than earnings gains. The strength in earnings was partially offset by concerns that a trade war between the U.S. and its major trading partners could develop, potentially derailing the global economy. In addition, interest rates remain near their highest levels in the last five years and the Federal Reserve is poised to raise their target range for the Federal Funds rate several times this year. Rising interest rates raise costs for consumer and corporate borrowers, which could in turn slow economic activity. Rising rates also have the potential to compress stock price to earnings multiples as bonds become a more attractive alternative.

Factors other than valuation and fundamentals appear to be driving small cap stocks so far in 2018. An ETF tracking small cap stocks with strong price momentum rose 18% for the first nine months of the year, significantly outperforming the Russell 2000 Index's 11.5% return. The gap in year-to-date performance between Russell 2000 stocks with the highest P/E multiples (up 26.2%) and those with the lowest P/Es (up 2.3%) is the largest since the internet bubble year of 1999. In addition, stocks with no earnings at all are up 18% year to date. Money-losing stocks make up nearly one third of the small cap index, despite a strong environment for corporate profits. This year is on pace to be the busiest year for new IPOs since 2014, and 83% of those offerings involve companies that lost money the prior 12 months to going public, the highest percentage since the dot-com bubble. Stocks of money-losing companies listing in the U.S. were up 36% on average from their IPO price through September 27th. That is better than the 32% return for IPO stocks with earnings and the 9% gain for the S&P 500 Index.

Small cap stocks rose broadly for both the third quarter and first nine months of the year, with most sectors posting gains. The healthcare and communication services sectors were the best performing sectors over both time frames. Those sectors tend to have a large proportion of high P/E, non-earning, or high price-momentum stocks, allowing them to benefit from the market trends mentioned previously.

Portfolio Review

The composite generated a 0.3% return for the third quarter, compared to a 3.6% return for the Russell 2000 Index and a 1.6% return for the Russell 2000 Value Index. For the first nine months of the year, the composite generated a 2.9% return, versus an 11.5% return for the Russell 2000 Index and 7.1% return for the Russell 2000 Value Index.

Skyline's investment style focuses on companies that are selling at low valuations relative to current or previously demonstrated earnings. As previously discussed, higher P/E and non-earning companies significantly outperformed stocks with lower P/E multiples so far in 2018, creating a difficult environment for our style of investing. In addition, our process looks for inflection points in company fundamentals and the market's assessment of those fundamentals. In momentum-oriented markets, stocks that are already doing well are rewarded by investors regardless of valuation. Those that have not performed as well but may be poised to improve tend to underperform.

The consumer discretionary sector was the largest contributor to the composite's absolute performance during the third quarter, but was the largest detractor to absolute performance year to date. Contributing to the third quarter's performance was Aaron's, Inc. (AAN), a lease-to-own retailer of home goods, which responded positively to better than expected earnings. AAN's Progressive virtual lease-to-own offering is gaining meaningful traction with traditional retailers. Detracting from year-to-date performance was LCI Industries, a manufacturer of components for recreational vehicles. LCI was among the largest detractors to the composite's performance year to date despite posting high-teen organic revenue growth. A rapid rise in steel and aluminum prices is causing temporary gross margin pressures. Given LCI's strong market position, we believe it will successfully pass those costs on to its customers allowing its gross margins to return to historic levels.

The industrials sector detracted from the composite's absolute performance during the third quarter due in part to weak performance at a number of its residential housing-related companies, including American Woodmark Corporation, JELD-WEN Holdings, Inc., Beacon Roofing Supply, Inc., and BMC Stock Holdings, Inc. We continue to believe that long-term demographic trends and a rebound in home ownership levels will allow the housing market to withstand the recent rise in interest rates.

The information technology sector contributed most to the composite's absolute return for the first nine months of the year. Zebra Technologies Corporation, a manufacturer of products for automatic identification, was the largest individual contributor to performance year to date. Zebra's automatic identification and data capture equipment is benefitting from the need for companies to manage their supply chains more efficiently.

Sector allocation was a positive contributor versus the Russell 2000 Value Index during the third quarter, due in part to a lack of exposure to the poor performing energy and consumer staples sectors. Sector allocation vs. the Russell 2000 Value Index was negative for the first nine months of the year due in part to our clients' portfolios' relatively low weighting in the strong performing communication services sector.

Sector allocation was negative for the third quarter and year to date when compared to the core Russell 2000 Index. Primary contributors during both periods were relatively low weightings in the outperforming healthcare and communication services sectors.

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Outlook

The outlook for earnings remains solid. The median current fiscal year expected EPS growth for the companies in our clients' portfolios is over 20%, driven by a healthy U.S. economy, lower corporate taxes, and company-specific factors. The biggest risks to those expectations are increasing trade tensions and higher interest rates. We are optimistic trade tensions won't escalate to a level that would derail U.S. GDP momentum. And absent a dramatic spike, we believe the economy can withstand a gradual rise in interest rates.

Valuations remain reasonable. The P/E on forward 12 month earnings of the companies in our clients' portfolios at the end of the third quarter was 14.6x. This is a meaningful discount to the Russell 2000 Index's 19.4x multiple.

The recent success of high P/E stocks, non-earnings stocks, and/or stocks with the best price momentum create a difficult environment for Skyline's fundamental, value-oriented approach. We have witnessed periods like this over the 25+ years of investing in small cap value stocks. Therefore, we believe that while it is difficult to predict when these trends will reverse themselves, we are confident that they eventually will, to the benefit of 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: Bloomberg L.P.; Invesco Ltd.; Jefferies LLC; RBC Capital Markets; Robert W. Baird & Co. Incorporated; State Street Global Advisors; Stephens Inc.; SunTrust Robinson Humphrey; The Wall Street Journal; Yardeni Research, Inc.; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.