Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

September 30, 2019

Overview

The composite generated a -1.3% return for the third quarter, compared to a -2.4% return for the Russell 2000 Index and a -0.6% return for the Russell 2000 Value Index. For the first nine months of 2019, the composite generated an 18.4% return, compared to a 14.2% return for the Russell 2000 Index and a 12.8% return for the Russell 2000 Value Index.

The modest decline in small cap stocks during the third quarter masked significant intra-quarter volatility. Investor sentiment alternated between optimism about a more accommodative monetary stance by central banks around the world and a strong U.S. consumer on one hand, and concerns about growing trade friction between the U.S. and China and a slowing industrial economy on the other. A noteworthy development late in the quarter was the shift by investors away from sectors of the market that have been the best performers over the last several years to those that have underperformed over the same time period.

Year-to-date returns reflect strong performance earlier in the year as investors took the view that the deceleration in the U.S. economy was temporary and not an indication that a recession was imminent.

The composite outperformed the Russell 2000 Index and underperformed the Russell 2000 Value Index for the third quarter and outperformed both indexes for the first nine months of the year. Sector allocation was positive and stock selection detracted from performance relative to both benchmarks during the third quarter. Both sector allocation and stock selection added to performance against both benchmarks for the first nine months of the year.

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. We are encouraged by the reversal of those trends late in the third quarter. As a result, we are optimistic about the opportunity for our clients' portfolios if earnings meet their more modest expectations.

Market Review

Stocks were mixed during the third quarter, as indicated by returns of -2.4% for the Russell 2000 Index, -0.6% for the Russell 2000 Value Index, and 1.7% for the S&P 500 Index. Year to date, the Russell 2000 Index is up 14.2%, the Russell 2000 Value Index is up 12.8%, and the S&P 500 Index is up 20.6%.

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For much of the last year, stocks have fluctuated as investor's were confronted with conflicting signals as to the direction of the market. On the positive side were a healthy U.S. consumer, more accommodative monetary policies by major central banks, and attractive valuations in certain segments of the market. When news of those factors was at the forefront, stocks rallied. When headlines were dominated by reports of slowing overseas economies and increasing trade frictions, stocks declined.

Meanwhile, interest rates declined sharply. As yields on bonds decline, those provided by stocks become more attractive, all else being equal. However, concurrent with the decline in interest rates, the outlook for corporate earnings has diminished. Investors had to weigh whether a more favorable backdrop for equity valuations was enough to offset lower than expected earnings.

Continuing trends that had been in place for several years, for most of the last twelve months large cap stocks outperformed small cap stocks, growth stocks outperformed value stocks, and the market was led by those stocks with the best price momentum. Those trends reversed, to varying degrees, late in the quarter. In September, small cap value stocks outperformed small cap growth stocks by nearly 600 basis points, its widest margin of monthly outperformance since September of 2008. Momentum strategies, where investors buy those stocks that had the best price performance for the prior twelve months, also performed poorly during September. In addition, several rapidly growing, money-losing firms either postponed their IPO (WeWork, Endeavor Group, ADC Therapeutics) or saw their share prices decline sharply following their IPO (Peloton, Uber, Lyft, SmileDirectClub).

Although one month does not constitute a trend, we are encouraged by signs that investors are placing more emphasis on valuations following a long period where only growth rates seemed to matter. We can't point to any specific event that caused the reversal of recent trends. However, in our opinion, disparities in valuations between small and large stocks and value stocks and growth stocks reached unsustainable levels and a correction was inevitable.

In light of investor concerns about the pace of economic growth, real estate, utilities, and consumer staples, all sectors considered less sensitive to changes in the economy, performed best in the third quarter. In addition, real estate and utilities in particular tend to have higher dividend yields so they became more attractive amid the decline in interest rates during the quarter. Conversely, economically sensitive sectors like energy, materials, and industrials all posted declines during the quarter.

Almost every sector in the small cap market was up for the first nine months of the year, with a notable exception being energy stocks, which declined along with a declining oil rig count. Economically sensitive sectors such as industrials performed well, but so did more defensive sectors like real estate and utilities. Among the sectors considered to have the best growth prospects, information technology stocks were strong performers, while health care stocks trailed the index.

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Portfolio Review

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The information technology sector was a major contributor to the composite's absolute performance for both the third quarter and first nine months of the year. Perficient, Inc., an IT services provider, was a leading contributor to the composite's performance over both time frames. Perficient's stock responded positively to better than expected earnings driven by strong demand for its services that digitally transform its customers operations and processes.

The materials sector detracted from the composite's absolute performance for both the third quarter and first nine months of the year. Orion Engineered Carbons S.A., a producer of carbon black products, declined after the company provided a disappointing outlook based primarily upon weaker demand from overseas customers. We continue to hold the stock due to its strong long-term outlook and attractive valuation.

Advantageous sector allocation contributed to the composite's performance vs. both benchmarks during the third quarter and first nine months of the year. A lack of exposure to the poor performing energy sector helped relative to both benchmarks. A lower weighting relative to the Russell 2000 Index of the poor performing health care sector benefited performance. A higher weighting in the strong performing information technology sector relative to the Russell 2000 Value Index helped performance vs. that benchmark.

Stock selection detracted from the composite's performance relative to its benchmarks for the third quarter. Dine Brands Global, Inc., a franchiser of family and casual dining restaurants, declined due to lower than expected same-store sales at its Applebee's subsidiary. We believe Dine's earnings growth prospects remain solid and its current valuation is compelling.

Stock selection positively impacted the composite's performance relative to its benchmarks for the first nine months of the year. BMC Stock Holdings, Inc., a distributor of building supplies, was a leading contributor to the composite's return for both time periods. BMC delivered solid earnings despite a difficult housing backdrop due to continued outperformance of its value added products/services that save homebuilders time and money.

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Outlook

We believe the risk/reward for our clients' portfolios is attractive. The relative valuation of small cap value stocks remains attractive compared to large stocks and growth stocks, even considering their solid outperformance late in the third quarter. Despite the strong performance of the composite year to date, based upon analyst estimates, the forward 12 month P/E of its stocks is below 13x, which we believe provides some downside protection especially considering the returns available on other investment options. On the same basis, the P/E of the Russell 2000 Growth Index is trading over 23x forward estimates and the large cap S&P 500 Index is trading at 21x. A 13x P/E is even more compelling when considering the returns available from fixed income securities in an environment where the yield on the 10 Year U.S. Treasury note is around 1.5%.

We currently expect the companies in our clients' portfolios to generate EPS growth of about 7% over the next twelve months. 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. In addition, earnings growth in the very short term will be limited given the difficult comparisons they are facing relative to a year ago. 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.

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: Barrington Research Associates, Inc.; Bloomberg L.P.; Deutsche Bank Securities Inc.; Jefferies LLC; Northcoast Research Holdings, LLC; Stephens Inc.; The Wall Street Journal; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.