Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

September 30, 2020

Overview

The composite generated a 6.0% return for the third quarter, compared to a 2.6% return for the Russell 2000 Value Index and a 4.9% return for the Russell 2000 Index. For the first nine months of 2020, the composite generated a -18.0% return, compared to a -21.5% return for the Russell 2000 Value Index and a -8.7% return for the Russell 2000 Index. Stocks continued their rebound in the third quarter, recouping more of the losses they suffered earlier in the year. Although the U.S. economy has bounced back sharply from the pandemic-related weakness earlier in the year, the path to full recovery remains uncertain.

The composite outperformed both the Russell 2000 Value Index and the Russell 2000 Index during the third quarter. Stock selection and sector allocation were positive versus both benchmarks. Year to date, the composite outperformed the Russell 2000 Value Index due to advantageous sector allocation over the first nine months of the year. 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.

Evidence of heightened speculation in equity markets abounds. We believe this is most clearly manifested in a large cap growth stock bubble, indicated by the recent wide disparity in stock price performance between large cap and growth stocks on one hand and small cap and value stocks on the other. This has driven relative valuations between large cap growth stocks and the rest of the stock market to levels we believe are unsustainably wide. In similar instances in the past, the gap in valuations narrowed meaningfully leading to significant outperformance by value-oriented strategies like the one used to manage our clients' portfolios. We don't see any reason to believe the current bubble will not follow the same pattern.

The U.S. economy has rebounded sharply from the depths of its pandemic-related lows. The recovery has been uneven, with some sectors of the economy fully recovered while others remain deeply depressed. 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 over the last two quarters, the valuations of our clients' portfolios' holdings remain attractive, particularly when compared to the stock market as a whole and other investment alternatives.

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Market Review

During the third quarter, the Russell 2000 Value Index rose 2.6%, the Russell 2000 Index rose 4.9%, and the S&P 500 Index rose 8.9%. Year to date, the Russell 2000 Value Index has generated a -21.5% return, the Russell 2000 Index a -8.7% return, and the S&P 500 Index a 5.6% return.

Recent economic reports indicate that the U.S. economy is making solid progress from its lows earlier in the year. New orders for durable goods bottomed in April and have risen every month since then. New home sales have jumped 77.4% over the past four months through August, to their highest levels since 2006. Retail sales bounced back more quickly than expected from their recessionary levels, helped by higher unemployment benefits and other government stimulus programs. Through September, the U.S. has replaced just over half of the jobs lost at the beginning of the pandemic.

After having slashed corporate earnings estimates early in the pandemic, analysts are now raising them in response to the faster than anticipated improvement in the economy and now expect them to be above pre-pandemic levels in 2021. In addition, the Federal Reserve committed to near-zero interest rates until at least 2023, even if inflation exceeds the Fed’s target. Low interest rates provide a positive backdrop for equity valuations by making the returns on alternative investments like bonds less attractive.

Among small cap stocks, sector performance reflected an economic environment that was improving faster than expected. Economically sensitive sectors such as industrials and materials were among the best performers. Consumer stocks were also strong, reflecting the rebound in consumer spending. Defensive sectors like utilities and real estate were among the weaker performers. Financials stocks lagged as the combination of higher loan losses and lower interest rates weighed on bank valuations. Energy stocks declined due to lower oil prices.

For the first nine months of 2020, the Russell 2000 Value Index fell 21.5%, the Russell 2000 Index fell 8.7%, and the S&P 500 Index rose 5.6%. The strong stock price rebound in the second and third quarters moved large cap stocks back into positive territory for the year but was not enough to offset steep first quarter declines for small cap stocks, small cap value stocks in particular.

Healthcare was the best performing small cap sector on a year-to-date basis reflecting investor preference for growth-oriented stocks. Consumer stocks also posted positive returns for the first nine months of the year, as consumer spending has held up well despite a spike in unemployment. 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.

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The Russell Top 200 Growth Index, representing the largest U.S. growth stocks, generated a return of 41.2% over the last twelve months vs. -3.9% for the largest value stocks and 0.4% for small cap stocks. We believe these relative returns are reflective of a growth stock bubble similar to the Nifty Fifty Era of the early 1970s and the internet and growth stock bubble of the late 90s. In both of these previous instances, the bubbles burst as, for the most part, growth expectations proved to be unrealistic. Even companies that continued to demonstrate high levels of earnings growth saw their stock prices disappoint as their P/E multiples contracted to levels more reflective of their long-term prospects. The bursting of those bubbles ushered in long periods of significant outperformance by value oriented strategies like those used in managing our clients' portfolios.

Portfolio Review

The composite generated a 6.0% return for the third quarter, compared to a 2.6% return for the Russell 2000 Value Index and a 4.9% return for the Russell 2000 Index. Sector allocation was advantageous vs. both benchmarks as was stock selection, especially vs. the Russell 2000 Value Index.

The industrials sector contributed most to the composite's absolute and relative performance during the third quarter. Building products companies BMC Stock Holdings, Inc. and JELD-WEN Holding, Inc. were among the top contributors to the composite's performance during the quarter. A strong 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. Also, a larger rival made an offer to acquire BMCH in August. The stock increased 22% after the merger announcement.

The information technology sector was also a major contributor to the composite's absolute and relative returns during the third quarter. Virtusa Corporation, an IT services provider, was a major contributor to the composite's performance during the quarter. Virtusa announced that it was going to be acquired by a private equity firm for a share price that was about 27% above the level it traded at just prior to the announcement.

Our clients' portfolios' financials sector was the only one to post a negative return during the third quarter. Bank stocks were weak due to concerns about the impact of increasing loan losses and low interest rates on bank earnings.

The consumer discretionary sector detracted most from the composite's performance relative to its benchmarks during the third quarter. Winnebago Industries, Inc., a manufacturer of recreational vehicles, was a significant detractor during the quarter.

Winnebago's business remains quite strong and despite the stock price decline in the third quarter, remains one of our clients' portfolios' top contributors year to date.

The composite generated a -18.0% return for the first nine months of the year, compared to a -21.5% return for the Russell 2000 Value Index and a -8.7% return for the Russell 2000 Index. Sector allocation was advantageous vs. both benchmarks due in part to underweighting in the poor performing energy sector and an overweighting in the relatively strong performing industrials sector. Stock selection detracted from the composite's performance relative to both benchmarks, but to a much greater degree vs. the core Russell 2000 Index. Stock selection was particularly difficult in the healthcare and information technology sectors. Those sectors have a higher proportion of faster growing companies that sell at valuations above what our investment discipline allows. Faster growing companies significantly outperformed value-oriented companies for the first nine months of the year.

Every sector of our clients' portfolios with a meaningful weighting generated negative returns for the first nine months of the year. The industrials sector was our clients' portfolios' best performer, for sectors with a meaningful weighting, relative to its benchmarks. TPI Composites, Inc., a manufacturer of blades for wind turbines, was one of the top contributors to the composite's performance year to date. In addition to reporting solid earnings results, TPI announced contracts that highlighted the continuing trend by wind turbine manufactures to outsource the manufacture of blades to specialists like TPI.

Outlook

The composite generated a 33.9% return over the second and third quarters of 2020, compared to a 21.9% return for the Russell 2000 Value Index and a 31.6% return for the Russell 2000 Index. The strong performance on both an absolute basis and relative to its benchmarks is consistent with our belief that our clients' portfolios perform best in the period spanning from the late stages of an economic downturn to the early part of the subsequent recovery. The relative performance continues well into the economic expansion, leading to what we believe is solid long-term relative performance despite heightened volatility at turning points in the cycle.

Skyline's valuation discipline prevents us from owning the fastest growing companies. Our requirement for above average earnings growth leads us away from the slower growing, more defensive sectors like utilities and real estate. Therefore, stocks that best fit Skyline's investment process tend to be concentrated in more economically sensitive sectors. In the early part of an economic recovery, their earnings outlooks improve along with the economy and their valuations rebound from their recessionary lows. The combination of increasing earnings and improving valuations leads to strong price performance.

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Skyline's investment process seeks to identify companies with strong company-specific earnings growth drivers. Therefore, we expect them to not only benefit from an economic recovery, but to continue to show above average earnings growth through improving margins and by taking share from weaker competitors as the economic cycle matures.

Although the prices of the stocks in our clients' portfolios have rebounded sharply from their lows earlier in the year, valuations remain quite attractive. In addition, we believe we remain early in an economic recovery and our clients' portfolios' company-specific opportunities remain intact, which we believe should lead to a sustained period of above average earnings growth. Taken in isolation, the combination of attractive valuations and the expectation for above average earnings make us optimistic about the outlook for our clients' portfolios. When compared to other areas of the market, the case for our clients' portfolios is even more compelling.

Evidence of excessive speculation abounds in the market. With three months left on the calendar, U.S.-listed initial public offerings have raised nearly $95 billion. That already surpasses the totals of every year, except 2014, since the tech bubble in 2000. If the current pace keeps up, 2020 will eclipse the tech-boom years of 1999 and 2000, when investors snapped up internet stocks before they crashed to Earth. About a third of IPO's by volume have been Special Purpose Acquisition Companies (SPACs). SPACs are essentially blank-check companies. SPAC founders form the company and go out and raise a few hundred million dollars through an IPO, with the intent of buying another company with the money they have raised.

The large cap indices are dominated by a handful of mega-cap technology and consumer stocks. Apple Inc., Amazon.com, Inc., Facebook, Inc., Alphabet Inc., and Microsoft Corporation recently made up about 23% of the S&P 500 Index, the highest concentration in at least 30 years, and trade at a median 35x this year's earnings. Apple reached $2 trillion in market capitalization, making it worth more than all of the small companies in the Russell 2000 Index combined, or the FTSE 100 Index, which tracks the biggest companies listed on the London Stock Exchange.

Individual investors made up roughly 40% of market trading during the first six months of 2020, up from about 25% in 2010. Individual investors helped drive Tesla, Inc. to a year-to-date gain of over 400% at one point late in the third quarter, making it the most valuable auto maker in the world, passing Toyota Motor Corporation. Tesla delivered less than 400,000 cars in the 12 months ended March 31, while Toyota sold nearly 10.5 million vehicles during the same period, about ten times as many as Tesla has built in its lifetime.

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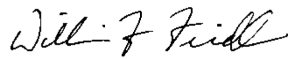
We believe like all previous occurrences, the current period of excessive speculation will eventually come to an end, causing massive losses for investors caught up in the frenzy. At that point, as in the past, strategies like Skyline's that rely on rigorous fundamental analysis and attention to valuation will demonstrate the value they add to investors.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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.; BTIG, LLC; Builders FirstSource, Inc.: The Channel Company; Industry Dive; Jefferies LLC; MarketWatch, Inc.; Nasdaq, Inc.; Reuters; S&P Global; SGB Media; Statista; Stifel Financial Corp.; The Wall Street Journal; Yardeni Research, Inc.; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.