Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

December 31, 2017

Overview

The composite generated a 1.2% return for the fourth quarter, compared to a 3.3% return for the Russell 2000 Index and a 2.1% return for the Russell 2000 Value Index. For the full year 2017, the composite increased 9.7%, while the Russell 2000 Index rose 14.7% and the Russell 2000 Value Index increased 7.8%. During the fourth quarter, economically sensitive sectors performed best, while gains were more broad-based for the full year.

During the fourth quarter, the composite underperformed both of its indexes due primarily to unfavorable stock selection. For the full 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 2017. The composite outperformed the Russell 2000 Value Index for the full year due to advantageous sector allocation.

The near term outlook for earnings is positive given a favorable global economic backdrop and the expected benefits of corporate tax reform. However, valuations remain towards the high end of their historical ranges, leaving little downside protection in case of disappointments.

Market Review

Stocks rose during the fourth quarter, as indicated by the Russell 2000 Index's 3.3% increase, the 2.1% return generated by the Russell 2000 Value Index, and the S&P 500 Index's 6.6% increase. The solid fourth quarter performance helped drive gains for the year of 14.7% for the Russell 2000 Index, 7.8% for the Russell 2000 Value Index, and 21.8% for the S&P 500 Index.

Stocks responded favorably to an improving backdrop for earnings growth. Economies throughout the world are showing signs of acceleration. In the U.S., GDP grew at 3.3% during the third quarter, its strongest showing in 3 years, and the Atlanta Federal Reserve's GDP model is projecting similar growth for the fourth quarter. U.S. manufacturing is strong, as indicated by September's ISM manufacturing purchasing managers index (M-PMI) reaching its highest level since 2004. Outside the U.S., all 45 countries tracked by the OECD are expected to expand in 2017, something that has occurred rarely over the last fifty years and most recently a decade ago.

Stocks also reacted positively as investors began to factor in the benefits of a decline in the statutory U.S. corporate tax rate to 21% from 35%. Not all of that benefit is likely to be reinvested by companies or competed away, providing a boost to earnings in 2018 and beyond.

During the fourth quarter, the positive outlook for global GDP led to strong performance by economically sensitive sectors such as energy, consumer discretionary, industrials, and materials. More defensive sectors like real estate and utilities lagged during the quarter. Most sectors performed well for all of 2017, with healthcare and industrials particularly strong. Energy stocks were among the worst performers for the year, despite oil ending the year above $60 per barrel, the highest level in over two years.

Small cap growth stocks significantly outperformed small cap value stocks for both the fourth quarter and full year 2017. For the fourth quarter and full year the Russell 2000 Growth Index was up 4.6% and 22.2%, respectively, while the Russell 2000 Value Index was up a more modest 2.1% and 7.8%. Growth stocks outperformed their more value-oriented counterparts across most sectors during both time periods. Heavier weightings in the strong performing industrials, healthcare, and information technology sectors also helped the growth index's year-to-date returns relative to the value index.

Large cap stocks outperformed small cap stocks during the fourth quarter and full year 2017. The Russell 2000 Index was up 3.3% for the quarter and 14.7% for the year, while the S&P 500 Index rose 6.6% and 21.8% over the same time frames. Large companies grew their earnings faster than small companies, in part due to their greater percentage of foreign sales, which allowed them to benefit from improving overseas economies and a weaker dollar. In addition, the strong performance by technology/consumer mega caps – Apple Inc., Facebook, Inc., Amazon.com, Inc., Microsoft Corporation, and Alphabet Inc. – accounted for almost one quarter of the S&P 500 Index's return in 2017.

Portfolio Review

The composite generated a 1.2% return for the fourth quarter, compared to a 3.3% return for the Russell 2000 Index and a 2.1% return for the Russell 2000 Value Index. For the year, the composite was up 9.7%, versus 14.7% for the Russell 2000 Index and 7.8% for the Russell 2000 Value Index. Our clients' portfolios are constructed to own stocks with the best combination of value and earnings growth. Therefore, it does 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 did 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, our clients' portfolios tend to perform better than the value benchmark when growth stocks outperform.

The industrials sector contributed most to the composite's absolute performance in the fourth quarter and for all of 2017. EnPro Industries, Inc., a manufacturer of gaskets, seals, and compressor components, was a solid contributor during both periods. EnPro reported better than expected earnings as the company was able to take advantage of improving industrial end markets.

Among individual stocks, The Children's Place, Inc., a retailer of children's apparel, contributed most to the composite's absolute return for both the fourth quarter and year-to-date periods. Children's Place has delivered strong results despite the headwinds facing mall-based retailers by improving its systems and merchandising and taking share from weaker competitors. Virtusa Corporation, an offshore IT service provider, was a significant contributor to the composite's absolute return for both the fourth quarter and full year periods. Virtusa reported better than expected earnings as strong organic growth with new and existing customers drove top line growth and margin expansion.

The composite underperformed the Russell 2000 Value Index during the fourth quarter but outperformed it for all of 2017. Adverse stock selection in the information technology and healthcare sectors hurt relative performance during the quarter. An adverse patent ruling at Veeco Instruments Inc., a manufacturer of equipment to produce LEDs, contributed to its weak price performance during the quarter and year. The uncertainty created by the ruling caused us to reassess our investment thesis, resulting in the sale of the stock. Within healthcare, Acadia Healthcare Company, Inc., an operator of mental health facilities, declined due to worse than expected results in its recently acquired U.K. operations.

The composite outperformance relative to the Russell 2000 Value Index for the full year was due primarily to advantageous sector allocation. A lack of exposure to the poor performing energy sector and a heavy weighting in the strong performing industrials sector were the main contributors.

The composite underperformed the Russell 2000 Index during the fourth quarter and year to date. As mentioned previously, we typically are not able to invest in the fastest growing companies due to our valuation discipline. Those stocks performed well this year, and tend to be concentrated in the information technology and healthcare sectors. In addition, our clients' portfolios were negatively impacted by adverse stock selection within these sectors.

Outlook

The fundamental backdrop for earnings growth is positive. The global economy is experiencing its most synchronized expansion in a decade. U.S. GDP grew 3.3% in the third quarter, and the outlook remains positive. The current U.S. administration is committed to reducing the impact of regulations on businesses and the passage late in the year of comprehensive tax reform, including a meaningful reduction in the U.S. corporate tax rate, should help the economy and corporate profits.

According to a leading small cap equity strategist, the combination of a strong global economy and lower corporate tax rates could lead to EPS growth of greater than 20% in 2018, which would be a significant positive for small cap stocks.

In light of the positive outlook for earnings, small cap stocks continue to trade towards the high end of their historical valuation range. Even when factoring in the new, lower corporate tax rates, small cap valuations remain above their long term averages. We believe current valuations are a reflection of the low returns available on alternative investments like bonds in a low interest rate environment. In our opinion, it is critical for companies to deliver their expected earnings, as there is little valuation support for disappointments.

We are confident the fundamentals of the companies in our clients' portfolio 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 its benchmarks. We believe our clients' portfolios are well positioned to take advantage if earnings improve as we expect.

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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: Federal Reserve Bank of Atlanta; Jefferies LLC; Morgan Stanley & Co. LLC; Sidoti & Company, LLC; Stephens Inc.; Stifel Financial Corp.; SunTrust Robinson Humphrey; Telsey Advisory Group; The Wall Street Journal; Yardeni Research; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.