Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

December 31, 2018

Overview

The composite generated a -20.3% return for the fourth quarter, compared to a -20.2% return for the Russell 2000 Index and a -18.7% return for the Russell 2000 Value Index. For all of 2018, the composite generated a -17.9% return, versus a -11.0% return for the Russell 2000 Index and a -12.9% return for the Russell 2000 Value Index.

Stocks plummeted in the fourth quarter, eliminating the gains generated earlier in the year. Throughout the year headlines were dominated by news of slowing overseas economies, an inverting yield curve, a weakening U.S. housing market, and increasing trade tensions. These concerns intensified in the fourth quarter, forcing investors to contend with the possibility that the U.S. economic growth would slow dramatically, if not fall into a recession, in 2019.

The composite performed in line with the Russell 2000 Index and modestly underperformed the Russell 2000 Value Index in the fourth quarter, and trailed both indexes for all of 2018. Stocks with the highest P/Es significantly outperformed lower P/E stocks during 2018, 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 outlook for earnings growth has become less certain given the headwinds buffeting the U.S. economy. In addition, the stock market and the treasury yield curve, which often act as leading indicators of the economy, are flashing warning signals. However, the employment situation remains robust and for the most part, indicators point to continued, albeit slower, economic expansion. In addition, equity valuations have fallen to their most attractive levels in years, indicating the diminished earnings outlook is largely reflected in stock prices.

Market Review

Stocks fell during the fourth quarter, as indicated by returns of -20.2% for the Russell 2000 Index, -18.7% for the Russell 2000 Value Index, and -13.5% for the S&P 500 Index. For the full year, the Russell 2000 Index generated a -11.0% return, the Russell 2000 Value Index declined 12.9%, and the S&P 500 Index returned -4.4%.

The Russell 2000 Index's 11% decline in 2018 was its fourth worst annual performance since the index was created in 1984. The index fell 27% from August 31st to December 24th, surpassing the 20% decline generally considered the definition of a bear market.

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The steep decline in stock prices during the fourth quarter came despite solid current fundamentals. Fourth quarter U.S. GDP is estimated to have grown 2.6%, providing a solid backdrop for earnings, which for small cap companies are estimated to have grown 12%. Although solid, that earnings growth rate did reflect a deceleration from the rate achieved earlier in the year.

Stock price weakness was more a reaction to several warning signals pointing to a meaningful slowdown in economic activity entering 2019. Among the indicators concerning investors were struggling overseas economies, including the world's second largest, China. Slower overseas growth contributed to a decline in core capital goods orders in three of the four months ending in November. Global trade tensions and a steep drop in oil prices were also likely contributors to declining order rates. A weakening U.S. housing market was another red flag.

Also disconcerting to investors was the behavior of indicators thought to be good predictors of future economic activity. In somewhat self-fulfilling fashion, the steep decline in stock prices increased the likelihood of a recession in the near term. Credit spreads, the premiums on investment grade bonds compared to government debt, also widened late in 2018, another sign of investor concern over the direction of the economy.

Another recession predictor, a negative interest rate spread between the 10 year U.S. Treasury bond and 3 Month Bills, came dangerously close to being realized late in the year. When short-term interest rates exceed long-term rates, banks may find it less profitable to lend, potentially dampening business investment. Concerns intensified late in the year when the Federal Reserve indicated it would continue to target higher short-term rates. The announcement was contrary to investors' expectations that the Fed would suspend its rate hikes in light of recent market volatility.

Stocks were weak across the board with all sectors declining for both the fourth quarter and every sector but utilities declining for the full year. Sectors more exposed to the global economy, including energy, materials and industrials, were among the worst performers over both periods. Healthcare stocks were also quite weak during the fourth quarter, reversing their strong relative performance earlier in the year.

For all of 2018, the Russell 2000 Growth Index declined 9.3%, outperforming the Russell 2000 Value Index's -12.9% return. Within the Russell 2000 Value Index, stocks with the highest P/Es fell 8.4% for the year, significantly outperforming the lowest P/E stocks, which fell 19.8%. Growth stocks tend to be less economically sensitive, and late in the cycle, investors are willing to pay up for companies they believe will grow earnings even in the face of decelerating business activity.

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Portfolio Review

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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 stocks significantly outperformed stocks with lower P/E multiples 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 like 2018, 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. By one measure, small cap stocks with the best momentum outperformed those with the worst momentum by almost 1300 basis points in 2018.

Every sector of our clients' portfolios posted declines in the fourth quarter, and all but healthcare were negative for the full year. The industrials sector had the largest negative impact on the composite's absolute performance during both periods due to its large weighting and poor performance of stocks within the sector. NN, Inc., a manufacturer of high precision components, was a major detractor. We eliminated our position in NN during the fourth quarter because the company's business model transformation was not generating the benefits expected.

Investment Technology Group, Inc., an electronic brokerage firm, was the largest contributor to the composite's performance during the fourth quarter. ITG announced it agreed to be acquired for a price that was 40% above the level it was trading at prior to the first media reports it was in discussions to be sold. The Ensign Group, Inc., a nursing home operator, contributed most to the composite's performance for the year as improving occupancy at acquired facilities drove strong earnings results.

On a relative basis, the composite performed in line with the Russell 2000 Index and slightly underperformed the Russell 2000 Value Index during the fourth quarter, and underperformed both benchmarks for the full year. Positive contributors to relative performance during both periods were a lack of exposure to the poor performing energy sector and strong stock selection within the healthcare sector.

Weak performance of our client's portfolios' industrials sector was the largest detractor from its relative performance for both the fourth quarter and full year, due in part to weak performance at a number of its residential housing-related companies, including American Woodmark Corporation, JELD-WEN Holding, 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 rebound from current weakness. A lack of exposure to the outperforming utilities sector also detracted from the full year's relative performance.

Outlook

Several headwinds to earnings growth have emerged, including slowing overseas economies, a weaker U.S. housing market, a decline in durable goods orders and certain commodity prices, and tighter financial conditions. Concerns about trade tensions and tariffs are impacting business sentiment. In addition, several leading economic indicators, including stock prices, a flattening yield curve, and wider credit spreads, are all pointing to reduced economic activity. Although these are components of the Conference Board's index of leading economic indicators, they are not infallible predictors. To quote the economist Paul Samuelson, "the stock market has predicted nine out of the last five recessions."

For the most part, economists have scaled back estimates for U.S. GDP in 2019 but still see growth. In December, the Federal Reserve cut its estimate of growth to 2.3%, down from 2.5% previously. A recent survey of economists by the Wall Street Journal put the odds of recession over the next twelve months at 22%, up from 14% a year earlier but still well below recession odds of 36% just before the last downturn. Underpinning the growth outlook is high consumer confidence. The University of Michigan consumer sentiment index remained near its 14 year high in late December, as consumers appeared to be undaunted by recent market volatility. Confidence is being bolstered by low unemployment, strong payroll growth, rising wages, and strong household balance sheets.

The combination of sharp price declines and solid earnings growth has caused equity valuations to improve dramatically. As calculated by S&P Capital IQ, our clients' portfolios' trailing 12 month P/E ended the year at 15.4x, its lowest year-ending level since the depths of the financial crisis in 2008. We believe adjusting the earnings to reflect our estimates of soon-to-be-reported fourth quarter 2018 figures and the elimination of certain nonrecurring items provides a more accurate picture of our clients' portfolios' valuation. On that basis, it is trading at 11.6x earnings. The only time our clients' portfolios traded at a valuation meaningfully lower than today over the last 25 years was during the financial crisis of 2008-2009.

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Because current valuations are so attractive, we believe that the outlook for our clients' portfolios is quite positive over the next 3 to 5 years. If the economy grows in 2019, we are also optimistic about the near-term outlook for our clients' portfolios. If the economy falls into a recession, our clients' portfolios might face additional volatility before rebounding. Our confidence stems from our long history of investing over many different stock market environments, including ones similar to the cycle in which we currently find ourselves.

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: Advisor Perspectives, Inc.; Bloomberg L.P.; The Conference Board, Inc.; Federal Reserve Bank of Atlanta; The Financial Times; FocusEconomics S.L.U.; Forbes Media LLC; FTSE Russell; Jefferies LLC; MarketWatch, Inc.; Sandler O'Neill + Partners, L.P.; TheStreet, Inc.; Stephens Inc.; The Wall Street Journal; William Blair & Company; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.