Skyline Asset Management, L.P.

Executive Summary

Skyline Small Cap Value Composite

December 31, 2019

Overview

The composite generated a 9.9% return for the fourth quarter, compared to a 9.9% return for the Russell 2000 Index and an 8.5% return for the Russell 2000 Value Index. For all of 2019, the composite generated a 30.2% return, compared to a 25.5% return for the Russell 2000 Index and a 22.4% return for the Russell 2000 Value Index.

The solid returns posted by stocks in the fourth quarter supplemented the gains generated earlier in the year, leading small cap stocks to their best year since 2013. The strong results reflect a rebound from depressed levels early in the year, a shift by central banks to more accommodative monetary policies as the year progressed, and an apparent easing of global trade tensions late in the year.

The composite performed in line with the Russell 2000 Index and outperformed the Russell 2000 Value Index for the fourth quarter and outperformed both indexes for the full year. Positive stock selection and negative sector allocation offset each other relative to the Russell 2000 Index during the fourth quarter, while positive sector allocation more than offset negative stock selection relative to the Russell 2000 Value Index. For all of 2019, strong stock selection benefitted performance versus both benchmarks.

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 these trends beginning in early September. As a result, we are optimistic about the opportunity for our clients' portfolios if earnings meet their more modest expectations.

Market Review

Stock prices rose sharply in the fourth quarter, as indicated by the 9.9% return for the Russell 2000 Index, the 8.5% return for the Russell 2000 Value Index, and the 9.1% return for the S&P 500 Index. The market reacted favorably to positive developments in two areas of concern for investors, monetary conditions and trade tensions.

The U.S. Federal Reserve's monetary policy became more accommodative during the year. The Fed reversed course and began lowering its targeted Federal Funds rate on July 31st, and followed up with two more cuts, one in September and one in October. As an indication of the impact of these cuts, the 3 month to 10 Year US bond yield spread, which was negative for most of 2019, turned positive in early October. A negative spread is considered a good predictor of recessions. The return to positive territory indicated the odds of a recession in the near term had lessened.

In December, the U.S. and China announced they had reached an agreement on a limited trade deal. The uncertainty caused by trade tensions has been cited as one of the biggest risks to continued economic growth and progress on that front eased investor concerns.

Small cap stocks outperformed large cap stocks during the fourth quarter as indicated by the Russell 2000 Index's 9.9% return compared to the 9.1% generated by the S&P 500 Index. Although modest, the outperformance continued the trend that started late in the third quarter.

Within the small cap market, the Russell 2000 Value Index's 8.5% return trailed that of the Russell 2000 Growth Index's 11.4% gain, suggesting that small growth stocks outperformed small value stocks during the fourth quarter. However, health care, due to its heavy weighting and a 32.1% gain by biotech stocks, contributed 6.3%, which was over half of the Russell 2000 Growth Index's 11.4% gain. This compares to 0.9% of the Russell 2000 Value Index's 8.5% gain contributed by health care. During the same period, of the index's ten other sectors, five Russell 2000 Value Index sectors outperformed their counterparts in the Russell 2000 Growth Index by more than 200 basis points, while only one growth sector did the same against its corresponding value sector.

In addition, within the Russell 2000 Index, the lowest P/E quintile rose 12.1% vs. the 7.0% gain recorded by the highest P/E quintile. In the Russell 2000 Value Index, the lowest P/E stocks rose 13.4% compared to 4.3% for the highest P/E stocks.

For all of 2019, the Russell 2000 Index generated a 25.5% return, the Russell 2000 Value Index rose 22.4%, and the S&P 500 Index increased 31.5%. Stocks rebounded early in the year from their steep declines in late 2018. As the year progressed, stocks benefitted from a more accommodative monetary policy and, late in the year, easing trade tensions.

Continuing trends that had been in place for several years, during the first eight months of the year, 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 third 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. The fourth quarter saw continued, albeit modest, outperformance by small cap and low P/E stocks.

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All sectors of the small cap market, with the exception of utilities, rose during the fourth quarter, with economically sensitive sectors among the best performers. For all of 2019, gains were broad based as every small cap sector, except energy, posted gains and among the gainers, only communication services failed to rise double digits.

Portfolio Review

The composite generated a 9.9% return for the fourth quarter, compared to a 9.9% return for the Russell 2000 Index and an 8.5% return for the Russell 2000 Value Index. For all of 2019, the composite generated a 30.2% return, compared to a 25.5% return for the Russell 2000 Index and a 22.4% return for the Russell 2000 Value Index.

We are pleased with performance this year. The composite kept pace with its benchmarks early in the year when the market, driven by growth and momentum stocks, was not conducive to our style. When trends reversed and value stocks took the lead, the composite significantly outperformed its benchmarks, which was consistent with how we believe it should.

	Performance	
	1/1/2019-8/31/2019	9/1/2019-12/31/2019
Composite	11.56%	16.69%
Russell 2000 Index	11.85%	12.23%
Russell 2000 Value Index	7.31%	14.06%
S&P 500 Index	18.34%	11.11%
Russell 2000 Growth Index	16.30%	10.48%
Momentum ETF (MTUM)	22.01%	4.56%

The information technology sector was the largest contributor to the composite's absolute and relative performance for both the fourth quarter and full year. Silicon Motion Technology Corporation (SIMO) and KEMET Corporation, two recent additions to our clients' portfolios, were the biggest contributors to fourth quarter performance. SIMO, a provider of flash memory controllers, responded positively to better than expected earnings. Demand for SIMO's controllers are benefitting as PC manufacturers switch from hard drives to more efficient solid state drives, a transition we believe is in its early stages. KEMET, a manufacturer of electronic components, rose when it announced it was being acquired by a competitor at a price that was 18% above the level it was trading at prior to the announcement.

In addition to KEMET, Versum Materials, Inc., a manufacturer of chemicals used in semiconductor production, and Anixter International Inc., a distributor of specialty wire and cable products, each received takeover offers from multiple parties. Electronics For Imaging, Inc., an industrial inkjet manufacturer, was acquired by a private equity firm earlier in the year. The increased level of takeover activity is a positive indicator of the attractive valuation of our clients' portfolios' holdings.

Every sector of our clients' portfolios posted gains for the fourth quarter. Health care, despite solid absolute results, detracted most from the composite's results relative to its benchmarks. The lack of exposure to strong performing biotechnology stocks prevented the sector from matching the gains of the benchmarks.

The real estate sector detracted most from the composite's absolute performance and was a major detractor from relative performance versus both benchmarks for all of 2019. Realogy Holdings Corp., a residential real estate broker, declined as a slower housing market and increased competition led to reduced earnings expectations. After reassessing the competitive environment and its impact on the company, the stock was sold.

Additions to our clients' portfolios during the fourth quarter included Focus Financial Partners Inc., a wealth management firm, and TPI Composites, Inc., a manufacturer of blades for wind turbines. We believe Focus is attractively valued despite being well positioned to be the consolidator of choice in the steadily growing registered investment advisor market. TPI is also attractively valued despite a solid backlog and the opportunity for significant margin expansion.

During the fourth quarter, we eliminated several positions due to lost confidence in managements' ability to execute their business plans. Among those sold were Plantronics, Inc., a manufacturer of communications equipment, Granite Construction Incorporated, a heavy civil engineering and construction company, and NOW Inc., a distributor of oilfield equipment. In addition, Banc of California, Inc., a commercial bank, and Janus Henderson Group plc, an asset manager, were sold in favor of higher confidence stocks. Zebra Technologies Corporation, a manufacturer of products for automatic identification and an outstanding performer during its holding period, was sold as it met our price target.

Outlook

During the last three years, investors have favored large cap stocks over small cap stocks, growth stocks over value stocks, and defensive stocks over economically sensitive stocks. FTSE Russell calculates a vast array of indexes to isolate market trends. The

Russell 200 Growth Defensive Index, which is made up of the largest, faster growing, and more defensive stocks, is up 76.6% over the last three years. The Russell 2000 Value Dynamic Index, which consists of smaller, lower valuation, and more economically sensitive stocks, is up 7.1% over the same period of time.

One might argue superior earnings growth accounts for the disparity in returns, and to an extent that is true. However, P/E multiple expansion has been a big factor as well. Take for example Apple Inc. and Microsoft Corporation, two stocks that together accounted for 15% of the S&P 500 Index's 31.5% gain in 2019. Apple stock is up 165% over three years, its earnings are up 44%, and its P/E has nearly doubled. Microsoft is up 166% over the same time frame, its earnings are up 76%, and P/E ratio is up 50%.

In contrast, the following holdings were all among our clients' portfolios' top ten in early 2017.

	2017 EPS	12/31/16 Price	P/E	2020E EPS	12/31/19 Price	P/E	Earnings Growth	P/E Change
BMC Stock Holdings, Inc.	1.02	19.50	19.12	2.10	28.69	13.66	105.9%	-28.6%
Essent Group Ltd.	3.08	32.18	10.45	5.86	51.99	8.87	90.3%	-15.1%
First Busey Corporation	1.74	28.34	16.29	2.22	27.50	12.39	27.6%	-23.9%
Knoll, Inc.	1.39	25.62	18.43	2.37	25.26	10.66	70.5%	-42.2%

Several of our clients' portfolios' holdings have also generated solid earnings growth but have seen their P/Es contract, not expand.

We believe the discrepancy in performance among investment styles reflects investors' concerns that we are late in an economic cycle. In that environment, investors want liquidity and less exposure to the economic cycle, which can come through defensive sectors or companies that can grow through any economic environment. Persistently low interest rates in the United States and about $15 trillion of government bonds worldwide trading with negative yields as recently as last August further highlights investor caution.

We may indeed be on the brink of a recession, although we don't believe that is the case. In fact, a case can be made that the economy is set to accelerate given the massive monetary stimulus being provided by central banks worldwide. Economic forecasting is not one of our competitive advantages. However, the valuations of the types of companies we invest in compared to most other sectors of the market provide a compelling risk/reward tradeoff in this uncertain economic environment.

At 26.7x, as calculated by Jefferies Financial Group Inc., the P/E of the Russell 2000 Growth Index is about 70% higher than that of the Russell 2000 Value Index, compared to a long term average of about 40%. In addition, defensive sectors like utilities (26.7x P/E), real estate (28.5x), and health care (25.5) are all trading at 20% to 50% above their long-term average P/Es. These sectors make up about a quarter of the Russell 2000 Value Index but typically make up a small percentage of our clients' portfolios. The sectors that typically make up the largest percentage of our clients' portfolios, including information technology, consumer discretionary, industrials, and financials, are all trading much closer to their long-term average valuations.

Based on our calculations, the median P/E on trailing twelve month earnings for the stocks in our clients' portfolios is approximately 14x, which is towards the lower end of its historical range. 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 reflective of a relatively slowly growing global economy and lingering trade tensions. These estimates could prove conservative if the economy does perform better than expected, which we believe it could. Either way, given current valuations, we believe the outlook over the next several years is positive.

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: Apollo Global Management, LLC; Bloomberg L.P.; CNBC LLC; Dow Jones & Company, Inc.; FTSE Russell; Jefferies Research Services, LLC; MarketWatch, Inc.; Needham & Company, LLC; The New York Times Company; Robert W. Baird & Co. Incorporated; Saint Bitts LLC; Stifel Financial Corp.; The Wall Street Journal; S&P Capital IQ; Morningstar, Inc.; and Skyline Asset Management, L.P.