Walthausen Small Cap Value Fund

Quarterly **Fund Commentary**

Ticker Symbol: WSCVX | **As of September 30, 2016**

Environment

2016 is proving to be a surprising year. After a tough January, the equity markets have marched up steadily with a gain every month. This is perplexing as there does not seem to be a good fundamental reason for these gains. Markets, having been in a steady upward march since 2011, seem fully priced. The economy seems to be in the doldrums with industry moving at well below capacity utilization while unemployment has been coming back down to reasonable levels. Casual observation suggests that we are at functional full employment and there is real pressure starting to build on margins as wages start to increase. In fact corporate profits, which have been at good levels, are likely to come under pressure as managements have rebuilt their balance sheets, reduced costs and are endeavoring to grow profits through increasing sales in a weak demand environment. This has led to slower profit growth.

Leadership in Q3 shifted from yield stocks like Utilities, REITs and Consumer Staples to Information Technology and Healthcare. The pull back in yield stocks and near record high debt issuance may portend rates moving higher and we think that the excesses in the valuation of companies with high growth and little profits seem extended. Observationally, it seems as though investors are willfully neglecting to pay proper attention to the risk levels in these areas, largely predicated on the need for cash yield and the pursuit of excess returns. Warren Buffett put it aptly when he stated, “Only when the tide goes out do you discover who’s been swimming naked.” We believe the distortions created by low interest rates and the impact it has had on capital allocation may cause the tide to pull out when the environment changes.

The steady upward movement of the markets has continued in the face of the overwhelming evidence of real discontent in the country. Polls indicate that the majority of the electorate feels that the country is headed in the wrong direction in spite of a lengthy recovery. The presidential campaign now seems a bit like Kabuki Theater and the market appears, right or wrong, unconcerned. We recently noted that for the first nine months of this year the stocks of companies with negative returns on equity were performing much better than the stocks of companies with returns on equity of greater than 12%. The market is rewarding the companies that are destroying value while penalizing those who are building value. We believe that as economic and market cycles move toward their final stages, investors are increasingly tolerant of risk and it seems to us that the current market environment is no different.

Performance Review

Portfolio Factors

Uncharacteristically, we fell behind in our selection, the area we have provided the greatest value since our inception. Our selection penalized us across almost all sectors and was most notable in Healthcare and Industrials. Ordinarily, during times of underperformance we have been able to attribute most of the underperformance to one or two bad selections but that is not the case this quarter.

Conversely, our performance was aided by our allocation this quarter. We saw a positive allocation effect with a significant underweight to Utilities and absence of REITs, along with our allocations to Materials and Industrials. We highlight the portfolio’s positioning in Utilities and REITs as our absence there has been a drag in recent quarters. We have voiced our concern in prior commentary regarding bond proxy stocks and the potential downside they can experience in a rising rate environment. This quarter those sectors experienced notable sell offs and we believe they may continue to experience this effect. As such, we maintain our current underweight positioning.

Stock Selection: Contributors

Looking through each of the sectors we do not find that our stock selection added meaningfully to performance, with the exceptions coming in Utilities where our two holdings, SJW Corp., (SJW) a water utility, and Suburban Propane (SPH), a propane distributor. Both did better than the sector but neither was a major contributor.

Our best returning holdings were a diverse group including Dana Corp (DAN) a supplier of drive trains and axles for automobiles and off highway vehicles. Their markets are mixed but they are winning new business and the stock has been rewarded. We have taken some profits but continue to hold the name.

We also did well with Lydall Inc. (LDL), a producer of specialty materials used as thermal and acoustical barriers and as filtration media. We have owned that stock quite successfully for a number of years but we exited the position during the third quarter as we believed that it had achieved a full valuation.

We also did well with two housing related stocks, NMI Holdings, Inc. (NMHI) and M/I Homes, Inc. (MHO). NMI is a relatively new mortgage insurer. Due largely to the more stringent credit quality standards, their loan business is healthy and they have been able to grow through successfully managing their expenses. M/I Homes, a home builder with strong market positions in the mid-west, south and middle Atlantic regions has benefited from the gradual rebound of home building in those areas. We still see value in both companies and continue to hold them.

Addus Homecare rounds out the quarter's best performers. They provide home healthcare, a business which we find attractive. New management is, we believe, bringing a more disciplined approach to expansion and we are continuing to hold the stock.

Portfolio Contributors – Q3 2016

Security	Average Weight (%)	Contribution
Dana, Inc. (DAN)	1.54	0.59
NMI Holdings, Inc. (NMIH)	1.33	0.42
Lydall, Inc. (LDL)	1.18	0.41
M/I Homes, Inc. (MHO)	1.84	0.41
Horizon Global Corp. (HZN)	0.49	0.35

Stock Selection: Detractors

Surprisingly, given the scope of our underperformance there was neither an issue with a single company, nor was there a single theme. The largest negative impact came from Great Lakes Dredge & Dock (GLDD). This stock is well positioned in the dredging industry, a business which is relatively unaffected by the level of economic activity. We believe the company is positioned to benefit from several factors. First, harbor expansion is in great demand to accommodate new larger ships. Second, beach restoration is necessary after storms, especially in areas where tourism is a large part of the local economy. Third, the $20 billion Deepwater Horizon Oil Spill Trust fund created after the Deep Water Horizon disaster will in part go toward environment remediation. The stock has been under pressure recently because a couple of small acquisitions have gotten off to a rocky start. We like the opportunity and are sticking with this stock.

Short term issues played a part in the poor performance of LHC Group (LHCG) and Vista Outdoor (VSTO). We are holding on to both these stocks. We have exited American Public Education (APEI), a for profit education company that serves active military personnel and veterans. We believe in management's strategy and the current value is attractive but the headwinds facing the education industry are too great and we are exiting.

We also experienced a pullback in Cambrex (CBM), a stock which has done very well for us. We had taken profits by selling partial positions several times but continue to hold a position.

Portfolio Detractors – Q3 2016

Security	Average Weight (%)	Contribution
Great Lakes D&D (GLDD)	1.24	-0.26
Vista Outdoor, Inc. (VSTO)	1.30	-0.23
Amer. Public Ed., Inc. (APEI)	0.63	-0.21
LHC Group, Inc. (LHCG)	1.46	-0.19
Cambrex Corp. (CBM)	1.18	-0.17

Portfolio Changes

During the quarter we added seven positions, which is about average for us and exited eight names. There is no thematic constant in these changes. In several cases, Horizon Global (HZN), Huttig Building Products (HBP), Lydall (LDL), and Amkor Technology (AMKR) we sold because the stocks in our opinion had reached full valuation. In Hyster Yale (HY), TrustCo Bank (TRST) and Dime Community Bank (DCOM) we felt that management's ability to add value in the two year time frame was limited and we exited the names.

We found candidates across a variety of industries. We added Casella Waste Management (CWST), a stock that we have been following for some time and have reached the conclusion that the company is well positioned to add value as a regional waste collector and land fill operator. Triton International (TRTN), a lessor of shipping containers, was added as we concluded that the merger of Tal and Triton offered good opportunities for cost synergies. This merger will make the company the largest shipping container lessor and we concluded that the strain the shipping industry is undergoing creates an enhanced opportunity for this business. We believe the catalysts here are not currently recognized in the market. Their massive cash flow and the strong collateral characteristics of the containers make this stock a bargain as the industry has been recently punished.

We added BNC Bancorp (BNCN) and Heartland Financial USA (HTLF), two banks with good quality characteristics and opportunities to expand. We also repurchased Kaiser Aluminum (KALU), a stock which we had previously owned. They are a supplier of aluminum shapes to the aerospace and automobile industry and are seeing increased demand while at the same time benefiting from investments which are reducing costs and adding capacity. Two other additions were Stoneridge (SRI), an auto supplier, and Albany Molecular Research (AMRI), a pharmaceutical development company. Both were added on the strength of management's execution of major changes within those two companies.

Exhibit 1: Sector Allocation - % over/underweight vs. Russell 2000 Value Index

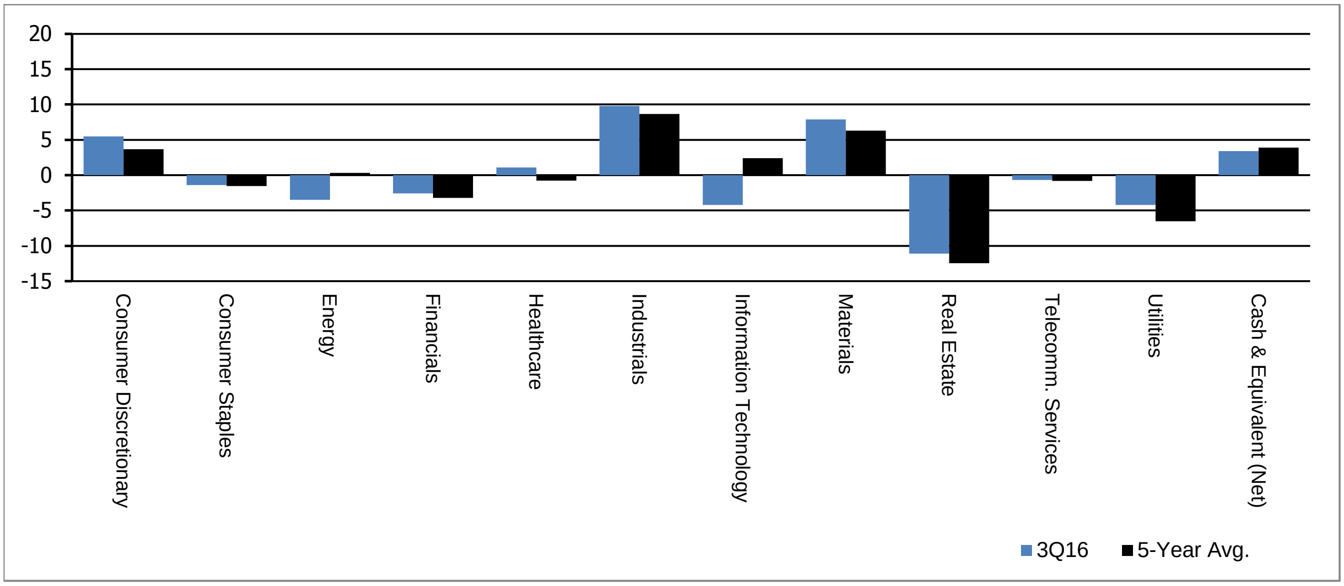

Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Outlook

We recognize that from time to time any investment style and process will find itself at odds with the market. We believe there are two larger factors attributable to this. First, given our style, it has been a challenge to beat the averages when the market has entered a mature phase such as the one we are currently in. As a consequence, this has led to a dearth of attractively priced companies demonstrating the types of change characteristics we are attracted to. The market deterioration that we saw late last year and through January ended without breaking the upward momentum of the market. Thus, this provided only a momentary opportunity to take advantage of mispricing before the resumption of the current trend. We saw that challenge in 2006 (at a prior firm) but our performance slip then was very modest. This time the difference has been more dramatic.

Second, we believe there are market distortions created by unprecedented low interest rates. Incontestably, our Federal Reserve and other central banks are using monetary policy to keep interest rates lower than they have ever been in an effort to drive economic growth. They seem to miss the fact that economic growth is a function of increasing productivity and other fundamental changes. Those conditions do not exist now. We believe that the economic growth, which we have enjoyed since the financial crisis, is due to; a restoration in confidence, new markets in China and other emerging economies, and finally the wealth and jobs created in the expansion of domestic energy production. Those factors are all played out.

The record low interest rates have created a "Free Money Bubble" which is creating capital allocation distortions. The market is experiencing money flows to public companies that are being valued as multiples of revenue, not earnings, cash generation or asset value. The money flow to the "unicorn" companies is directing capital away from the public markets as investors clamor for outsized returns. Most notably, we have seen an almost complete absence in private equity activity in our universe and we believe the unicorn effect is playing a role. We have seen this happen before during the dot.com phenomenon and believe that companies with fundamentally strong businesses that generate high cash flow and improving margins with management teams adept at allocating that capital toward growth will more consistently create value over time.

We are disappointed with the performance of late but believe that our process is sound and in the long term will prove highly effective. We believe that in the short term the "Invisible Hand" can act more like Ben Graham's "Mr. Market", where enthusiasm and fear can get the better of an investor. The market from time to time, spurred by major events, ceases to be an efficient allocator of capital and goes off in erratic directions. We don't know when it will shift back but we believe that it will happen.

Top Ten Holdings (%)

Mueller Water Products	2.3
LHC Group, Inc.	2.0
NMI Holdings, Inc.	2.0
Southside Bancshares, Inc.	1.9
Unifi, Inc.	1.9
Dana, Inc.	1.8
M/I Homes, Inc.	1.8
WSFS Financial Corp.	1.7
Lakeland Financial Corp.	1.7
Materion Corp.	1.7
Total % of Portfolio	18.80

Fund Statistics

	Fund	Russell 2000 Value Index
Number of Holdings	85	1,338
Median Market Cap (Billions)	$741.4	$620.8
Weighted Avg. Market Cap (Billions)	$1,115.3	$1,711.1
Price/Book[2]	1.4	1.3
P/E using FY1 Estimate[3]	16.5	16.4

Source: FactSet Research

Portfolio Performance

	Q3 16	1 Year	3 Year	5 Year	Since Inception (2/1/08)
Walthausen Small Cap Value Fund	6.74	12.16	2.93	15.68	12.30
Russell 2000 Value Index[1]	8.87	18.81	6.77	15.45	7.42

Total Expense Ratio: 1.25%. Expense ratio per the June 1, 2016 prospectus.

Performance data quoted represents past performance and does not guarantee future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The current performance may be lower or higher than the performance data quoted. Investors may obtain performance data current to the most month-end by calling (888) 925-8428. Periods over one year are annualized.

[1]The Russell 2000® Value Index measures the performance of the small cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth sales.

Disclosures

[2]Price/Book measures the weighted average of the price to book value of all the stocks in the fund's portfolio, excluding companies with negative book values. Book value is the total assets of a company less total liabilities.

[3]P/E using FY1 Estimate is a ratio reflecting the amount of earnings estimated for next year per dollar of amount share price. For the fund, the individual P/E stock ratios are then weighted by their portfolio and market values to calculate a weighted average for the portfolio as a whole. Companies with negative earnings are excluded from the calculation. This ratio is not a forecast of the fund's future performance.

An investment in the Fund is subject to investment risks, including the possible loss of the principal amount invested. The Fund invests in the stocks of small capitalization companies, which may subject the Fund to additional risks. The earnings and prospects of these companies are generally more volatile, and they may experience higher failure rates than do larger companies. Their stocks are subject to a greater degree of volatility, trade in lower volume and may be less liquid. Investment in the Fund is also subject to common stocks risk, value investing risk, sector risk, securities lending risk, and investment management risk. Fund holdings and asset allocations are subject to change and are not recommendations to buy or sell any security.

Investors should consider the investment objectives, risks, charges and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. You may obtain a prospectus by calling (888) 925-8428. The prospectus should be read carefully before investing. Distributed by Rafferty Capital Markets, LLC – Garden City, NY 11530, Member FINRA.

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Contributors and detractors performance data and analytics provided by FactSet. To measure performance for periods when portfolio holdings change, portfolio analysis calculates the security weights and returns on a daily basis, then geometrically link returns across the measurement period.

Walthausen Funds
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