Walthausen Small Cap Value Fund

Quarterly **Fund Commentary**

Ticker Symbol: WSCVX | **As of December 31, 2016**

Environment

What a fourth quarter! The raucous presidential election ended with a dramatic upset when the anointed successor was thrashed by Cincinnatus – 2017 version. As he lays aside his reality show and real estate promotions to take up the responsibilities of President, we are uncertain of his capabilities as he has never held public office. We would have expected the markets to retreat in fear. The analysts told us that he was the candidate of the struggling middle class out to dethrone the moneyed and powerful folks on the coasts. We expected that the moneyed folks would take their money and leave the market. Instead the markets surged forward on what had already been a good year for the market.

The economy in 2016 moved forward slowly. The growth seemed to falter a bit during the year. We think it could be a sign of fatigue as the current economic expansion ages or the effect of the slowdown in the domestic energy exploration. Even so, the economy seemed to pick up strength late in the year. All through the year employment grew slowly but steadily. In fact, despite what was frequently said, the US economy exited 2016 in rather good shape.

The New Year ushers in new uncertainty. While the economy is growing nicely, the unemployment rate has fallen far enough so that future growth is likely to create upward pressure on wages. We have also seen interest rates finally starting to inch up and the dollar has strengthened dramatically against most currencies including the EURO and the Chinese Yuan. Those factors, assuming they will slow, may impact profit growth.

Complementing the risk of a slower economic growth is an overextended stock market valuation. The Shiller PE ratio has surged to 28 times the inflation adjusted average of 10 year S&P 500 earnings. That is about 75% greater than the long term median and higher than at any time except 1929 and 2000. While some excess can be justified by the current low interest rates, we cannot expect that they will prevail forever and we must also remember that the US corporate profits have been at very high levels since emerging from the financial crisis of 2008.

A very high level of political uncertainty will go further to complicate an economy which is close to its cyclical peak, and a market with highly inflated equity valuations. The soon to be inaugurated Donald Trump is a well known figure on television, in the tabloids and in magazines but he has never held public office. While his campaign made a number of strong statements about what he planned to do, they were not backed up by policy details. They were in fact contradicted often and he many times pointed out that to effectively negotiate you don't want to show your hand. Even so, it is clear that he believes that tax code changes, tighter immigration and revised trade agreements are important to increasing American prosperity. Not all of these changes can be achieved without the cooperation of the legislature and given that he ran against many Republican doctrines and with a lack of government experience, it is reasonable to believe that changes in the law may not be easily achieved. However, the existing laws and treaties which cover our trade allow wide latitude. The President has the power to make large changes in trade. What we don't know is whether he sees trade as a good thing which can be made better by changing the terms or whether he believes that trade should be reduced in the interest of protecting American business. Further, we do not know how deft a President Trump will be in working to improve trade. If he is successful it could add to the strength and duration of the current expansion but if not it could begin a devastating trade war.

We are enthusiastic about the prospect of more infrastructure spending. We think that with the FAST Act[1] in place we are already starting to see more spending. The next level will require more legislation but there does seem to be a consensus that more of our infrastructure needs to be upgraded. Though we think that legislation will pass, it probably will not affect economic growth much this year.

Performance Review

Portfolio Factors

2016 has been a very difficult year for actively managed accounts and Walthausen & Co. did not escape the difficulty. As we have learned over the years, markets have minds and emotions of their own. This year the U S equity markets, after a trying start, enjoyed an excellent year with virtually every index well ahead. In the case of our Walthausen Small Cap Value Fund we enjoyed a similar experience. Surprisingly that did not meet or exceed the gain in our benchmark, the Russell 2000 Value index.

We have a hard time reconciling why the actively managed funds, ours included, so underperformed the index. As we looked at it we realized that the split between actively managed and passively managed funds is an over simplification. We define actively managed money as mutual funds and related accounts where managers select securities based upon a company's fundamentals. We define passively managed accounts as those where all the stocks are bought and sold to mirror their current proportion in a given index. In today's market, observers throw ETFs in with passively managed funds but this is dangerously incorrect. Though they are low cost and own a set group of stocks, they are designed for risk taking investors who wish to speculate on various themes, sectors, risk characteristics, etc. They, unlike mutual funds that cannot be traded throughout the day, have attracted a large inflow of capital and trade at furious rates. The consequence of that is that as they rebalance to accommodate inflows and outflows as speculators move, they buy and sell stocks daily in great volume. They have become the dominant buyer and seller of individual stocks, sweeping up stocks as a theme becomes popular and crushing them as the tide moves. We believe that this is a dangerous point in the market. Buyers and sellers of these securities take little or no note of the risks associated with the underlying securities; rather, they choose to move in unison with the momentum of the market. It seems as though these market participants have replaced the price setting mechanism that was held by the informed trading of active managers.

In the final quarter, after the election, the market gained new strength with value stocks running well ahead of growth and small cap way ahead of larger cap. While we benefited from this run up, it was also an unexpected sign of excessive speculative enthusiasm. The Financials were led by the banks where it appears that the prospect for faster economic growth and richer spreads have moved the sector higher. The Energy names also did well as it appeared that OPEC and other energy producing countries had agreed to limit production. For the Small Cap Value Fund, the fourth quarter surge provided an opportunity to catch up with the index. Allocation was about neutral as an overweight in Industrials offset low exposure in Energy and the drag of a cash position in a fast moving market.

Stock Selection: Contributors

The performance was driven by favorable selection. The gains were spread across the Industrial, Healthcare and Financial Sectors. In Industrials, which made up 22.7% of the portfolio, Tutor Perini (TPC) was the largest winner but others such as Columbus McKinnon (CMCO), ARC Document Solutions (ARC), McGrath RentCorp (MGRC) and Steelcase (SCS) all contributed.

In Healthcare, a smaller sector which accounted for 6.12% of the portfolio, the largest contributor was Addus HomeCare (ADUS). We have been skeptical about the outlook for oil and natural gas prices and thus were underweight in Energy. However, our major holding in that group, Era Group, Inc.(ERA), an operator of helicopters that are primarily used to support offshore exploration and production of oil and natural gas, did very well. The Financials, which no longer include REITs, did quite well without holdings of regional banks appreciating nicely but NMI Holdings (NMIH), a mortgage insurance company, was the top performer. Rounding out the top five was SeaWorld Entertainment (SEAS). SeaWorld's management is clearly doing the correct things to bring that amusement park company out of a very difficult position and redirect assets to high return projects.

Portfolio Contributors – Q4 2016

Security	Average Weight (%)	Contribution
ERA Group (ERA)	0.95	0.81
NMI Holdings, Inc. (NMIH)	2.14	0.79
Tutor Perini Corp. (TPC)	1.47	0.59
SeaWorld Entertainment (SEAS)	1.50	0.58
Addus Healthcare (ADUS)	1.52	0.58

Stock Selection: Detractors

For the quarter the detractors came from diverse industries. We have since reduced our holdings in Jakks Pacific (JAKK) when the toy maker reported that sales were falling short in spite of good reception of the movies that their toys were developed from. We also sold Convergys Corp. (CVG), a customer care company as we concluded that increased use of digital solutions was undermining Convergys' business model. We did elect to retain our holdings in Kindred Healthcare (KND), Suburban Propane (SPH) and Superior Industries (SUP). We are surprised that Kindred sold off after a decision to exit the skilled nursing facility business. We believe that this was a very constructive decision, fully in line with our understanding of trends in healthcare. We were also surprised by the decline in Suburban Propane. This limited partnership has a very stable business model of selling propane to residential customers. Though demand fluctuates a bit year to year depending on weather conditions, there is almost no sensitivity to propane prices. We consider that trading on weather expectations is poor use of resources and so have retained the position.

We also retained Superior Industries (SUP). The new management team has made great strides in improving returns. We consider that a period of operating inefficiency that results from very high demand must be considered as an expectable event.

Portfolio Detractors – Q4 2016

Security	Average Weight (%)	Contribution
Convergys Corp. (CVG)	1.17	-0.35
Kindred Healthcare (KND)	1.46	-0.30
JAKKS Pacific (JAKK)	0.44	-0.24
Suburban Propane (SPH)	1.57	-0.20
Superior Industries (SUP)	1.23	-0.19

Portfolio Changes

During the quarter we were relatively quiet selling only five positions. We exited Convergys (CVG) as we previously mentioned due to concerns about the effect of changes in customer use of digital technology on their long term outlook. We exited Briggs & Stratton (BGG) with some disappointment due to lack of progress in improving the corporate profitability and stock sales by corporate insiders which suggested that the improvements which we looked for were not going to be forthcoming. We sold Dime Community Bancshares (DCOM), because we considered that, unlike other bank holdings that we had, higher interest rates would be a challenge for this company. We sold Hope Bancorp (HOPE) because we have found that realizing the benefits of bank mergers, particularly mergers of equals can take a long time. We sold Lydall (LDL), an early holding in the fund at a very large gain. The company has done a great job in improving operations, shedding marginal operations and did a very good acquisition but the stock price began to fully reflect the improvements and the possible benefit of two recent acquisitions is less certain.

We added six positions. All of them, except for Wabash National (WNC), are only small positions as the fast moving markets of the fourth quarter has made it difficult to build positions at attractive prices. They are CVR Refining (CVRR), CVR Partners Ltd (UAN), Kimball International (KBAL), Orchids Paper Products (TIS) and Firstcash Inc., (FCFS). The only addition which is close to a full position has been Wabash National (WNC), a leading maker of truck trailers. We have owned the stock before and sold it when the market became too ebullient about its outlook. We saw an opportunity to add the stock again as investors became too concerned about an economic slowdown. We are impressed with management's willingness to innovate and their ability to generate very good returns on capital in a very cyclical business.

Outlook

We think that the economy most likely will continue to grow at a modest rate but think that rising wages, a strong dollar and higher interest rates will all conspire to hold down earnings growth. Those factors, combined with high market valuations and an increased level of political uncertainty make us cautious. We are not market timers but cash has crept up a bit as we have been cautious about adding to positions in a strong market. The names in the portfolio are financially strong with considerably better than average returns on invested capital. While we were disappointed in our inability to keep up with the benchmark in 2016, we believe that over time fundamental values are realized.

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

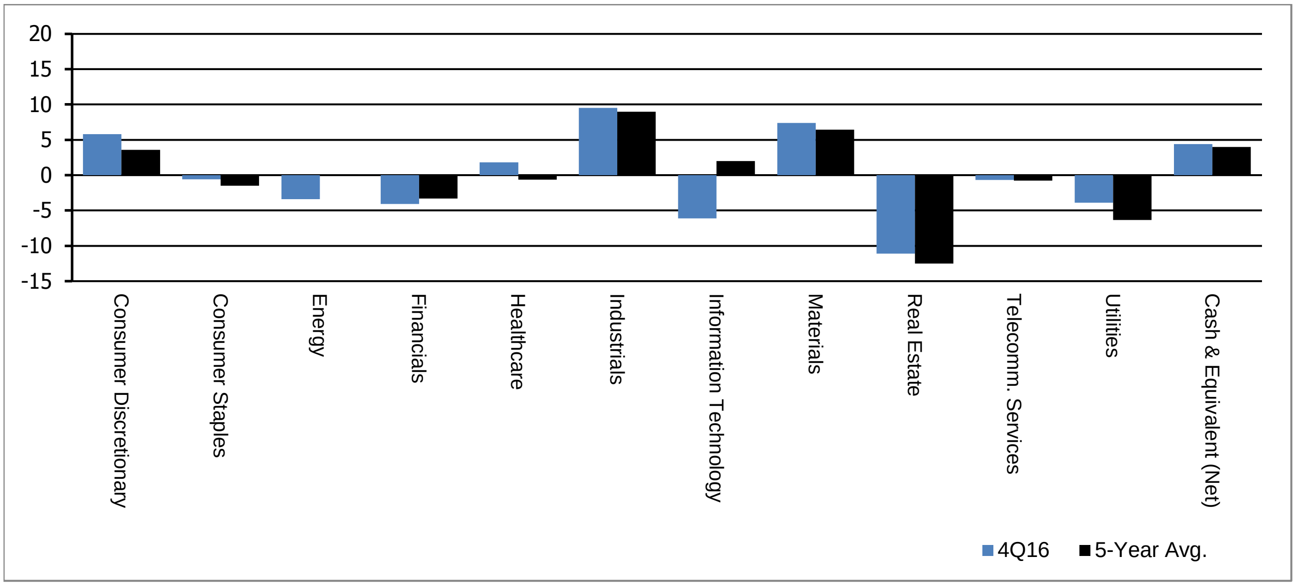

Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Top Ten Holdings (%)

NMI Holdings, Inc.	2.4
Southside Bancshares, Inc.	2.0
Unifi, Inc.	1.9
MGP Ingredients, Inc.	1.8
Navigators Group, Inc.	1.8
Ply Gem Holdings, Inc.	1.7
M/I Homes, Inc.	1.7
City Holding Company	1.7
Kindred Healthcare, Inc.	1.7
ILG, Inc.	1.6
	18.30

Fund Statistics

	Fund	Russell 2000 Value Index
Number of Holdings	85	1,369
Median Market Cap (Billions)	$830.7	$714.9
Weighted Avg. Market Cap (Billions)	$1,214.5	$2,006.8
Price/Book[2]	1.6	1.5
P/E using FY1 Estimate[3]	19.2	19.0

Source: FactSet Research

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Portfolio Performance

	Q4 16	1 Year	3 Year	5 Year	Since Inception (2/1/08)
Walthausen Small Cap Value Fund	17.39	30.99	5.90	16.24	13.96
Russell 2000 Value Index[4]	14.07	31.74	8.31	15.07	8.55

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.

[4]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

[1]On December 4, 2015, President Obama signed the Fixing America's Surface Transportation (FAST) Act (Pub. L. No. 114-94) into law—the first federal law in over a decade to provide long-term funding certainty for surface transportation infrastructure planning and investment. The FAST Act authorizes $305 billion over fiscal years 2016 through 2020 for highway, highway and motor vehicle safety, public transportation, motor carrier safety, hazardous materials safety, rail, and research, technology, and statistics programs.

[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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www.walthausenfunds.com