Walthausen Select Value Fund

Quarterly **Fund Commentary**

Ticker Symbols: Institutional Class WSVIX | Retail Class WSVRX

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

The Select Value Fund posted a gross quarterly return behind that of its benchmark, the Russell 2500 Value Index. While generally we can pinpoint the causes of quarterly performance, this quarter it proved difficult to identify the issues with any precision. Allocation attribution aided and the Utilities and REIT sectors, which in earlier quarters had been doing well, came under pressure. Our absence there was a benefit. When we look at selection attribution, sector by sector, our picks lagged and we can only put a small amount of the blame on the five worst performing stocks. We have selected companies which are well positioned, are prospering and returning well above their cost of capital. The market has been rewarding companies with negative returns on capital and it seems that our flavor of stock is distinctly out of favor.

Stock Selection: Contributors

The largest contributors came from the Industrials, Materials, Information Technology and Consumer Discretionary sectors. Our best performer was Trinity Industries (TRN) where an activist shareholder took a sizable position and that alone lifted the stock to a value where we elected to exit.

Westlake Chemical (WLKP), Jabil Circuit (JBL), and Restoration Hardware (RH) were relatively new positions where we thought that the market did not appreciate the potential of these companies. Each of the stocks has done well. While we continue to hold Restoration Hardware and Westlake, we have sold out of Jabil based on stock appreciation and took some profit in Restoration Hardware on a takeout rumor.

EMCOR Group (EME) also did well. We have held the stock for a number of years and are impressed with the management team’s steady execution of a sound strategy.

Portfolio Contributors – Q3 2016

Security	Average Weight (%)	Contribution
Trinity Industries, Inc. (TRN)	1.39	0.71
Westlake Chemical (WLKP)	2.48	0.56
Essent Group Ltd. (ESNT)	2.65	0.51
Jabil Circuit, Inc. (JBL)	2.62	0.47
Restoration Hardware (RH)	2.54	0.47

Stock Selection: Detractors

Our worst performing company was Textainer Group (TGH). We took a position late in the quarter with the stock under pressure resulting from a difficult time in the shipping business. We believe the container leasing business is valuable and in this case we think that the company came under selling pressure due to industry turmoil and was punctuated by management announcing a dividend cut. We think that this turmoil over the next several years will be a positive for Textainer and continue to hold the stock.

We also were hurt by Vista Outdoors (VSTO) a sporting goods supplier that reported a poor quarter largely due to the disruption caused by the liquidation of a major sporting goods retailer. We see opportunity and continue to hold the stock. We were also hurt by Clean Harbors (CLH), GNC Holdings (GNC) and Air Methods (AIRM), all of which we have exited.

Portfolio Detractors – Q3 2016

Security	Average Weight (%)	Contribution
Textainer Group (TGH)	1.93	-1.13
Vista Outdoor, Inc. (VSTO)	1.27	-0.58
GNC Holdings, Inc. (GNC)	0.80	-0.42
Clean Harbors, Inc. (CLH)	1.95	-0.27
Air Methods Corp. (AIRM)	0.68	-0.24

Portfolio Changes

During the quarter we sold seven positions and added a similar number. This was bit higher than usual. We mentioned earlier that we had sold Trinity and Jabil due to favorable price appreciation. We also exited from GNC Holdings. We were attracted to the good returns on invested capital GNC has and we believe that their strategy of selling store franchises is favorable. The fact that the company has begun to see an accelerated downturn in same store sales combined with a leveraged balance sheet suggested that though we may be leaving some value on the table we should look for a more promising opportunity.

In the case of Air Methods we became concerned that their accounts receivable continues to grow faster than revenue. They are in a somewhat difficult position as the medical evacuations are almost always done on an emergency basis which gives the paying insurance companies an opportunity to challenge the necessity of helicopter use after the fact. That then can stretch into a long payment negotiation and eventual compromise which makes it difficult for us to estimate what portion of the revenue is collectable. We again have elected to find a different stock.

We also exited Signature Bank (SBNY). They are in many ways well positioned but unfortunately their loan portfolio contains loans against taxi medallions. The emergence of Uber and similar ride sharing services has severely eroded the value of these medallions and it seems likely that Signature will be dealing with this problem for many quarters to come.

Our additions covered a variety of industries from propane distribution, Suburban Propane (SPH), to laboratory supplies, VWR Corp (VWR) to auto repair tools, Snap-On (SNA).

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 will more consistently create value over time.

Furthermore, we are largely in line with the benchmark in weighted average market cap, dividend yield and P/E. It is only when we get to return on assets and return on equity that we observe a real divergence from the benchmark. By design, when considering a stock for selection, we focus on a company's ability to generate excess cash (i.e. economic profits) and successfully reinvest those profits for the benefit of shareholders. So in essence, a key pillar to our investment philosophy is that money has cost associated with it.

We are disappointed with the performance of late but 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.

Exhibit 1: Sector Allocation - % over/underweight vs. Russell 2500 Value Index

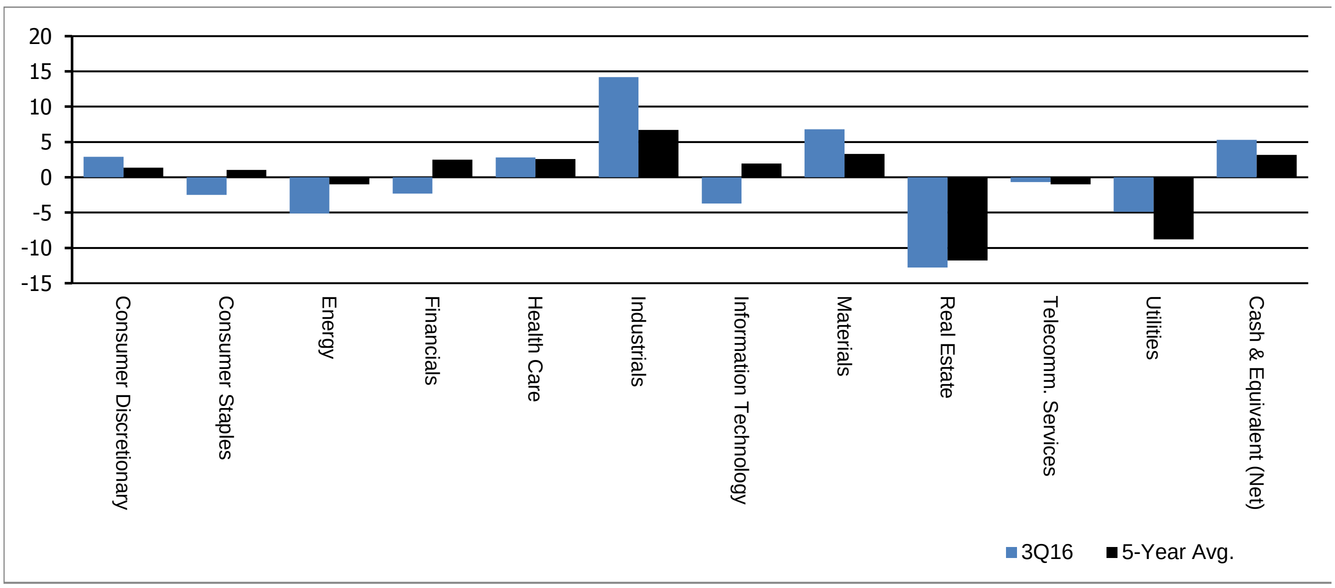

Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2500 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Walthausen Select Value Fund

Quarterly **Fund Commentary**

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As of September 30, 2016

Top Ten Holdings (%)

Kirby, Corp.	2.9
Moog, Inc.	2.8
Essent Group Ltd.	2.8
Westlake Chemical Corp.	2.8
Seaboard Corp.	2.7
GATX Corp.	2.7
AptarGroup, Inc.	2.7
HealthSouth Corp.	2.7
Independent Bank. Corp.	2.7
Avery Dennison Corp.	2.6
Total % of Portfolio	27.4

Fund Statistics

	Fund	Russell 2500 Value Index
Number of Holdings	39	1691
Median Market Cap (Billions)	$2,979.5	$932.2
Weighted Avg. Market Cap (Billions)	$3,211.5	$3,862.7
Price/Book[2]	1.7	1.5
P/E using FY1 Est[3]	16.6	16.8

Source: FactSet Research

Portfolio Performance

	Q3 16	1 Year	3 Year	5 Year	Since Inception (12/27/10)
Walthausen Select Value Fund: Institutional Class	2.83	6.46	2.96	15.10	9.44
Walthausen Select Value Fund: Retail Class	2.72	6.16	2.68	14.81	9.15
Russell 2500 Value Index[1]	6.18	17.68	8.05	16.29	10.54

Total Expense Ratio: 1.45%. Net Expense Ratio: 1.20% for Institutional Class, 1.45% for Retail Class. 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 2500® Value Index measures the performance of the small cap value segment of the U.S. equity universe. It includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth sales.

The Net Expense Ratio includes a waiver. The Advisor has contractually agreed to waive, for the Institutional Class Shares through May 31, 2017, 0.25% of the 0.45% Services Agreement fees applicable for Fund average daily net assets up to $100 million. The Advisor may not terminate the fee waiver before May 31, 2017. From the prospectus dated June 1, 2016.

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
(888) 925-8428
www.walthausenfunds.com