Walthausen Small Cap Value Fund

Quarterly **Fund Commentary**

Ticker Symbol: WSCVX | **As of December 31, 2017**

Environment

In our last quarterly commentary, we touched on investor complacency and the eleven consecutive quarters of gains the broader indices had experienced. Now it is fourteen quarters of uninterrupted gains, and despite starting at a very lofty valuation, the market was up nicely again in 2017. As unemployment has moved down to very low levels, the specter of rising wages and their impact on costs and profits along with the potential for inflation taking hold should, we thought, have caused investors to pause. We acknowledge that by many measures, the market is efficient, but in the great tug of war between buyers and sellers the balance is, to a large degree, ruled by animal spirits. These spirits can shift dramatically, particularly when investors are taken off guard.

Naturally, markets go up when there are more buyers than sellers, but why are there currently more buyers than sellers? We think that there are numerous reasons, the biggest of which is the fear of missing out. Investors do not want to be left behind and seem to be compelled to jump on board the market train since it has been steaming ahead at full speed for fourteen consecutive quarters. Despite numerous voices, including ours, raising caution over complacency and the apparent disregard for escalating risks, it seems as though the consensus opinion is that a body in motion tends to stay in motion until acted upon by an outside force.

What force may affect the market and when? There is no question that the market momentum shows little sign of abating. The new tax bill is a big bonanza to the corporate sector and to the economy overall. On the surface, the lower tax rate will help. We have been analyzing the impact the new rates will have on the companies that we hold. For some companies, the benefit looks to be substantial. The longer term economic impact, however, is not so certain. Congruently, money has never been cheaper and more readily available, particularly to businesses. We have seen the post crisis caution evolve into a much more ebullient spirit. Not much of that, however, is in the form of big capital spending. We are seeing this gradually creep up but most firms have the necessary physical capacity. The constraint is in labor and labor productivity. As a result, companies are showing much more enthusiasm to grow by acquisition and many of these deals are as reckless as we have ever seen. The deals come with promises of large synergies with little evidence to support them. As demand is increasing with a tight labor supply and increased deficits, we believe increasing inflation and higher interest rates become increasingly more likely. As such, this may be one force to act upon the current momentum.

For the full year, virtually every area of the market showed a positive result. Large caps beat small caps and growth once again trounced value. The momentum toward passive vehicles seems likely to continue as investors are using algorithms (not technical analysis – its discredited ancestor) to divine the trend and capitalize on stock popularity based on various factors predicated on the idea that they can be one step ahead of the invisible hand by closely watching price trends.

We have been getting increasingly cautious for several years and at the start of 2017, we were convinced that the US equity markets were much more likely to fall than rise. We were wrong, however, despite our view we performed well, beating our benchmark by a reasonable level. Our duty is to examine companies whose value suggests investor skepticism and make judgments regarding their ability to create shareholder value over time while also balancing the risks involved in achieving that goal. Sometimes, that requires making judgments that are not shared by investors in general. This is what we do irrespective of sentiment. Year 2017 was no different and we did not make any unusual moves. We continued to cull names from the portfolio and replace them with names that met our criteria. We were more selective than ever, as we saw many management teams shifting from cost and debt reduction to a search for a dramatic and generally very risky deal. As we enter 2018, we expect to continue that process while believing that our strategy will be generally well positioned.

Performance Review

Portfolio Factors

For the quarter end, Consumer Discretionary was surprisingly the index's best performing sector. We were aided by our full weighting but our selections there underperformed. The index's underperforming sectors were Real Estate, Information Technology, Healthcare, and Financials. Underweights in each of those sectors helped. Only an excess of cash detracted in sector allocation. We aim to be fully invested but have recently experienced two challenges. First, many of the candidates we did a deep dive on ended up making a risky acquisition and therefore we chose to avoid them. Second, a number of the stocks we selected had an uncanny way of moving up swiftly as we endeavored to accumulate a full position.

Stock Selection: Contributors

The best contributors emerged from a variety of industries. The leader was MGP Ingredients (MGPI), a distiller which, led by a new management team, has shifted its focus toward premium quality aged whiskies and away from lower value commodity alcohols. The improvement in profitability has been dramatic. We have taken some profits along the way but continue to hold the name.

We also did well with M/I Homes (MHO), a home builder with operations in the Midwest, Texas, the South and in the Middle Atlantic. Our thesis has been that the tighter mortgage rules were artificially restraining the demand for new homes and that this cycle would be more durable than most observers have suggested. We continue to believe that and still hold the stock. We also did well with Rogers Corp. (ROG), Primerica (PRI) and Winnebago Industries (WGO). Winnebago is a good example of a Walthausen stock. The company had a great brand and good reputation with customers but had lost focus. New management came in and began to make important changes. We were paying attention and were there before the stock started to react. We are aware that the RV industry is quite cyclical and have taken some profits while remaining involved.

Portfolio Contributors – Q4 2017

Security	Average Weight (%)	Contribution
M/I Homes, Inc. (MHO)	1.71	0.40
MGP Ingredients, Inc. (MGPI)	1.53	0.39
Rogers Corp. (ROG)	1.66	0.36
Primerica, Inc. (PRI)	1.67	0.36
Winnebago Industries (WGO)	1.48	0.34

Stock Selection: Detractors

The worst two performing stocks were names that had been plaguing us throughout the year. We continue to believe that both Vista Outdoor (VSTO) and Electronics For Imaging (EFII) have very significant value but have lost fans this year. In both cases, we think tax loss selling at year end added to the pain from loss of investor confidence. In the case of Vista, we think that the company overextended with some acquisitions and then was hurt by the squeeze which has put the entire sporting goods industry in a bind. While the company works through the industry-wide inventory problem, the new CEO, Christopher Metz, is reviewing the portfolio with an eye to effectively trim non-core business lines and to reduce debt. We remain invested in the position.

In Electronics For Imaging, we see a company with some very powerful technology advantages building into a much larger market. The distractions of these moves and the time between powerful new machines being introduced and brought online has caused some earnings disappointments but none, in our opinion, that detract from a bright long-term outlook. We are maintaining our position.

We were disappointed with Horizon Global (HZN). The company showed high potential when it was spun out of TriMas but now management is on a very aggressive acquisition program. We think that they are most likely biting off more than they can chew and have exited the position.

We also did poorly with two financial stocks. We have exited Eagle Bancorp (EGBN), a stock which did well for us, however, when evidence emerged that there were conflicts of interest that were more troubling than had been disclosed we exited the position. The other detractor, Navigators Group (NAVG), disclosed several adverse adjustments to reserves. This was a very unusual event for this generally conservative company and thus we have elected to hold this stock.

Portfolio Detractors – Q4 2017

Security	Average Weight (%)	Contribution
Electronics For Imaging (EFII)	1.37	-0.46
Vista Outdoor (VSTO)	1.11	-0.46
Eagle Bancorp. (EGBN)	1.01	-0.28
Navigators Group (NAVG)	1.53	-0.27
American Vanguard (AVD)	1.71	-0.26

Portfolio Changes

In the fourth quarter we added five new stocks. Two were Energy names; Halcon Resources (HK) and Silverbow Resources (SBOW). We believe that both of these E&P names are well positioned with ample undeveloped acreage and strong balance sheets. This modestly increases our exposure to energy prices. We believe that energy prices had stabilized well below the highs of a few years ago but at levels which allow these two companies to prosper.

We also added Silgan Holdings (SLGN) and Rayonier Advanced Materials (RYAM). Both are prior holdings within the portfolio. We returned to Silgan because we like the considerable free cash flow the company generates and the stock has returned to a more attractive value. Additionally, we believe that management is well experienced and highly focused. We returned to Rayonier because of improving fundamentals in both the pulp market and several high potential investments that the company is making. We also added Primoris Services (PRIM), an engineer and construction company with a good record and a good portfolio of projects.

We exited four stocks. We mentioned earlier Eagle Bancorp (EGBN) and Horizon Global (HZN). We exited LHC Group (LHCG) because we believe their acquisition of a large competitor is at an exorbitant price, and likely offers fewer synergies than promised. We also exited our small position in Jakks Pacific (JAKK) as it became increasingly clear that the company is not able to compete effectively.

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

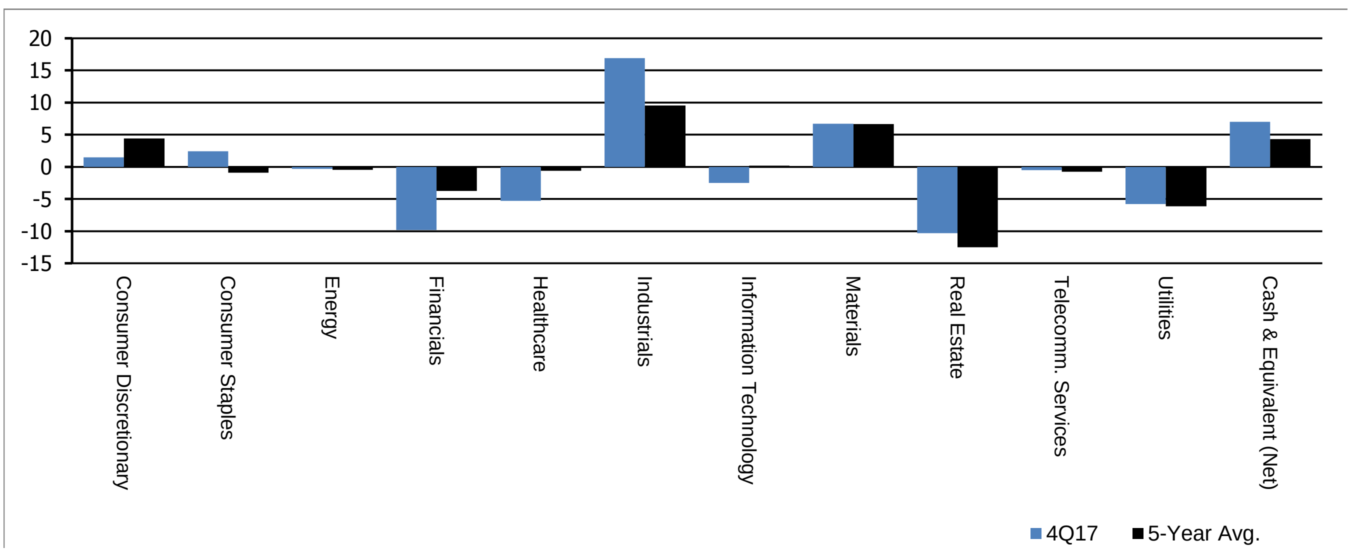

Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Top Ten Holdings (%)

Halcon Resources Corp.	1.9
Interface, Inc.	1.8
M/I Homes, Inc.	1.8
Casella Waste Systems, Inc.	1.8
Primerica, Inc.	1.8
McGrath Rentcorp	1.8
Unifi, Inc.	1.8
Mercer International, Inc.	1.8
Heritage-Crystal Clean, Inc.	1.7
Atkore International Group, Inc.	1.7
Total % of Portfolio	17.9

Fund Statistics

	Fund	Russell 2000 Value Index
Number of Holdings	81	1,387
Median Market Cap (Millions)	$982.7	$737.8
Weighted Avg. Market Cap (Millions)	$1,362.2	$2,065.9
Price/Book[1]	1.8	1.5
P/E using FY1 Estimate[2]	18.9	18.3

Portfolio Performance

	Q4 17	1 Year	3 Year	5 Year	Since Inception (2/1/08)
Walthausen Small Cap Value Fund	1.57	10.58	8.16	12.18	13.61
Russell 2000 Value Index[3]	2.05	7.84	9.55	13.01	8.48

Total Expense Ratio: 1.28%. Expense ratio per the June 1, 2017 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.

Disclosures

[1]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.

[2]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.

[3]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.

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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