## Environment

For quite a few quarters we have been wondering why large cap growth is out performing small cap value by massive amounts; why that continues and why the performance gap has been widening. Perhaps it is a harbinger of a shift back to a more normal time. A time when the warmth of investor enthusiasm shines on small cap value. In September, the small cap value segment of the market outperformed large cap growth. Perhaps this, and the spectacular unraveling of WeWork, will bring a new skepticism regarding the hyper growth model which has entranced the investment world. We are not sure that we have reached the turn, yet it does seem very likely, with the cumulative effect of the WeWork debacle, the poor reception of the Peleton (PTON) IPO, and the sharp decline of Uber (UBER) and Lyft (LYFT) stocks, that we may be seeing a shift in market direction. Even if October shows September to be a false signal, we think that the exhaustion of the hyper growth investment strategy is becoming very evident.

While investors have pulled back from that hyper growth investing we have seen that the economy is showing signs of slowing. We are all concerned that this could signal a recession. Recall that recessions are generally launched by a credit crunch or an energy shock. Neither of these events are easily predicted except after the fact. An energy shock does not seem likely with the ample oil and gas reserves that shale drilling is bringing on stream. Even the devastating attack on the Saudi facility failed to move oil prices up for more than a few days. Credit crunches are tough to predict. Almost certainly the extended period of growth and low interest rates have given ample opportunities for mistakes. We see the boom in venture capital as the signature excess of this expansion. As that winds down people will be hurt, but not in the broad and devastating way that the housing debacle and bank crisis hit the entire country. Employment is strong and wages are finally starting to rise particularly among lower income workers. We think that full employment and rising wages will sustain consumer spending. The housing market is healthy. Industrial activity, which has been stalled by the uncertainty surrounding trade activity, will respond favorably to consumer activity. While we continue to vigilantly observe, our current thought is that we may have a growth slowdown but not a recession.

We have been consistently and prematurely ready for investor interest in small cap value stocks. The Small Cap Value Fund has a weighted average market cap approximately 70% of the Russell 2000 Value benchmark and ROE is 70% higher at 11.3%. We are very happy with these numbers.

## Performance Review

**Portfolio Factors**

We are less pleased with our performance for the quarter with the Fund underperforming the Russell 2000 Value Index benchmark. Allocation was modestly positive with a pickup from being underweight in Energy which had fallen sharply. Though we were advantaged by the underweight in energy in terms of our holdings in that sector (averaging 2.78% of the portfolio compared to 5.85% in the benchmark), they were all the exploration and production companies. The E&P companies have become pariahs in the investment world. Their company's managements have taken the signal that investors are not enthusiastic and they have become more conservative, cutting drilling budgets, working hard to limit spending on new wells to available cash flow and concentrating spending on the most promising prospects. So far it is all for naught. As they have become more focused on cost, the wells are bringing in better returns, and the abundance of oil from the US is holding down world prices. Even the attack on the Saudi facility mentioned earlier produced only a hiccup in world prices.

The benefit of light holdings in Energy was offset by very meager holdings in the Real Estate and Utilities sectors, both of which did well as investors continued to value yield. We continue to be light in those sectors. We benefited from an overweight in the consumer sectors and an underweight in Healthcare.

In the second quarter we benefited from a substantial overweight in Industrials but gave up some ground because our selections were too conservative. In the third quarter, we saw the flip side. The sector was down more than the benchmark but our too conservative selections did quite well, so that in total it added nicely to our returns.

**Stock Selection: Contributors**

In the quarter, our two greatest contributors were housing related stocks; M/I Homes (MHO) and BMC Stock Holdings (BMCH). Both are well managed and prosperous companies, but we think the stocks responded well to the fact that the US housing market is healthy, and not overextended as it usually is after a period of economic expansion. Now they are benefiting from high levels of employment, rising wages and lower interest rates. Alamo Group (ALG) reported strong year over year second quarter improvement in industrial sales and margins and its backlog remains healthy, which was reflected well in the share price. Mobile Mini (MINI) and Lydall (LDL), the two other holdings which round out the top contributors, share the common characteristics of strong positions in their markets and good returns on invested capital. Both stocks had, in prior periods, lagged in spite of evidence that results were starting to improve.

**Portfolio Contributors – Q3 2019**

| Security | Average Weight (%) | Contribution |
|---|---|---|
| M/I Homes, Inc. | 2.72 | 0.69 |
| BMC Stock Holdings, Inc. | 1.97 | 0.44 |
| Alamo Group, Inc. | 1.95 | 0.36 |
| Lydall, Inc. | 1.35 | 0.35 |
| Mobile Mini, Inc. | 1.72 | 0.35 |

**Stock Selection: Detractors**

We sold out our positions in the two most disappointing stocks in the portfolio. Meredith (MDP) is a well-established publisher of lifestyle magazines and operator of a chain of television stations. Management has been doing a very admirable job of adjusting to the changes in the magazine business. In retrospect, we had to conclude that the acquisition of Time Inc. was too bold a move when the industry was in such turmoil. They did succeed in selling Time properties such as Time and Fortune at favorable prices, but they seem to have underestimated the time needed to rebuild the subscription base and the advertising support for the crown jewel People magazine. With the heavy burden of debt and preferred stock from the Time acquisition in mind, we have moved on.

Though in the end we did quite well with our purchase of MGP Ingredients (MGPI), delays by their customers in taking their aged bourbon whiskey made us worry that the enthusiasm for premium bourbon may have faded. We also could see that a large part of the bourbon market is overseas. In the trade disputes that are festering, a luxury product originating in Kentucky is an easy target. Consequently, we have exited the position.

The next three detractors were QEP Resources (QEP), SeaWorld Entertainment (SEAS), and Delphi Technologies (DLPH). QEP is a good E&P company and a large part of the decline derives from the selloff of the entire group. Beyond that, with the encouragement of Elliot Management, an activist shareholder who held almost 5% of the stock, the company explored strategic alternatives. Unfortunately, nothing happened, and with that, some shareholders departed. We continue to hold a moderate position in the stock.

SeaWorld, an amusement park operator, and Delphi, a vehicle parts maker, share the common factor of a new management group working hard to improve profits. We think that both of the teams have good plans and we are satisfied with progress. However, the stocks have failed to perform as the stock market has become increasingly skeptical regarding the efficacy of all the initiatives by new management groups.

**Portfolio Detractors – Q3 2019**

| Security | Average Weight (%) | Contribution |
|---|---|---|
| Meredith Corporation | 1.78 | -0.93 |
| QEP Resources, Inc. | 0.93 | -0.65 |
| MGP Ingredients, Inc. | 0.95 | -0.51 |
| Delphi Technologies, Plc | 1.12 | -0.39 |
| SeaWorld Entertainment, Inc. | 2.65 | -0.36 |

## Portfolio Changes

During the quarter we bought ten and sold ten stocks. This is a typical level of activity. From a portfolio structure perspective, the changes were modest with another small add to our Healthcare where, after seeing the group very overpriced earlier in the year, we are starting to find opportunities. We shaved back exposure to Energy names and with that shave, plus the Russell index shuffle, we have gone from market weighted to meaningfully underweight, albeit underweight relative to a small sector.

We also tiptoed into Real Estate. After diligent exploration we have established two small positions. The two REITs are similar in that they are well established, well financed and they grow value by actively managing their properties. Tanger Factory Outlet Centers (SKT) owns and manages outlet malls. As brand name apparel and footwear companies have adjusted to the internet selling and seen the decline of many department stores and malls, the outlet malls have become an integral part of their omni channel strategy. Tanger's malls are sizable and well located, mostly close to vacation destinations. The occupancy rates are good and leases are typically ten year. The balance sheet is strong. The stock has sold down in response to the challenges that apparel and footwear firms are facing. The second addition, UMH Properties (UMH), owns and manages mobile home parks. We find this an attractive business because manufactured homes are an increasingly attractive source of affordable housing.

The balance of the new holdings can best be described as a group of special situations. The common element is good returns on invested capital with prospects for improvement over time. We added Ameresco (AMRC) an engineering/construction company which specializes in energy efficiency including improving the energy efficiency of institutional and governmental complexes, as well as designing and building power generation using solar power and landfill gasses. The company presents a very interesting proposition as the majority of earnings now come from managing facilities that the company owns. Other stocks which we have added are Seacor Holdings (CKH), Intrepid Potash (IPI), Systemax (SYX), Vista Outdoor (VSTO), Natus Medical (NTUS) and Ultra Clean Holdings (UCTT).

On the sales side, we reduced our exposure to the energy sector by selling our positions in Gulfport Energy (GPOR) and SilverBow Resources (SBOW). Those two companies are primarily natural gas producers. Though drilling for natural gas has declined markedly, and the market for liquefied natural gas is healthy, the price for natural gas is too low and likely to remain low.

We sold Meredith Corp and MGP Ingredients for reasons which we noted earlier. We exited Global Brass & Copper (BRSS) after its acquisition by Wieland Group. We also sold Houston Wire & Cable (HWCC), Twin Disc (TWIN), Dave & Buster's (PLAY), Sally Beauty Holdings (SBH), and Andersons (ANDE). In general, we exited these positions because of disappointing execution.

## Portfolio Positioning

The portfolio continues to focus on a well-diversified collection of less well-known stocks. That is reflected in a weighted average market cap of about 70% of the Russell 2000 Value benchmark. The primary characteristic is that profitability as measured by return on assets and return on equity is much greater, historic and projected EPS growth is meaningfully higher, while valuations, when compared to the benchmark and to historic norms, are moderate.

# Walthausen Small Cap Value Fund

Quarterly **Fund Commentary**

**Ticker Symbols: Institutional Class WFICX | Investor Class WSCVX**

**As of September 30, 2019**

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

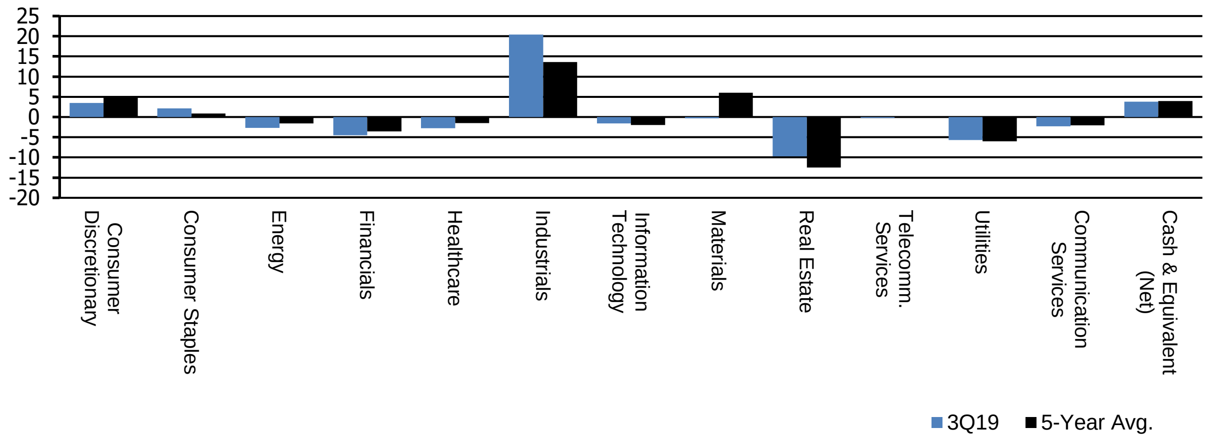


Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

### Top Ten Holdings (%)

| | |
|---|---|
| Landec Corp. | 2.5 |
| Great Lakes Dredge and Dock Corp. | 2.5 |
| Stewart Information Services Corp. | 2.5 |
| M/I Homes, Inc. | 2.4 |
| Primerica, Inc. | 2.4 |
| McGrath Rentcorp | 2.3 |
| Seaworld Entertainment, Inc. | 2.3 |
| Stoneridge, Inc. | 2.3 |
| AAR Corp. | 2.2 |
| Columbus McKinnon Corp. | 2.2 |
| Total % of Portfolio | 23.6 |

| **Fund Statistics** | **Fund** | **Russell 2000 Value Index** |
|---|---|---|
| Number of Holdings | 69 | 1402 |
| Median Market Cap (Millions) | $1037.5 | $642.4 |
| Weighted Avg. Market Cap ( Millions) | $1397.7 | $1996.7 |
| Price/Book[1] | 1.5 | 1.3 |
| P/E using FY1 Estimate[2] | 14.7 | 13.9 |

Source: FactSet Research

### Portfolio Performance

| | **Q3 19** | **1 Year** | **3 Year** | **5 Year** | **10 Year** | **Since Inception** | **Inception Date** |
|---|---|---|---|---|---|---|---|
| **Walthausen Small Cap Value Fund: Investor Cl** | -2.27 | -12.25 | 5.27 | 4.04 | 11.52 | 10.45 | 2/01/08 |
| **Russell 2000 Value Index[1]** | -0.57 | -8.24 | 6.54 | 7.17 | 10.06 | 7.01 | |
| **Walthausen Small Cap Value Fund: Institutional Cl** | -2.21 | | | | | 15.15 | 12/31/18 |
| **Russell 2000 Value Index[1]** | 0.57 | | | | | 12.82 | |

*Total Expense Ratio: 1.27%. Net Expense Ratio: 0.98% for Institutional Class, 1.21% for Investor Class. Expense ratio per the June 1, 2019 prospectus.*

*The Net Expense Ratio includes a waiver. The Advisor has contractually agreed to waive Services Agreement fees and Management Fees to the extent necessary to maintain total annual operating expenses of the Institutional Class shares and Investor Class Shares, excluding brokerage fees and commissions, taxes, borrowing costs (such as (a) interest and (b) dividend expenses on securities sold short), the cost of acquired funds and extraordinary expenses at 0.98% and 1.21% respectively, of its average daily net assets through May 31, 2020. The Advisor may not terminate the fee waiver before May 31, 2020. The Trustees may terminate the expense waiver upon notice to the Advisor. From the prospectus dated June 1, 2019.*

*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.*

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

*Return on Equity (ROE) is a profitability ratio that measures the ability of a company to generate profits from its shareholders' investments in the company.*

*Note that Peleton (PTON), Uber (UBER, Lyft (LYFT) and WeWork are not holdings of the Fund.*

*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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