Walthausen Focused Small Cap Value Fund

Quarterly **Fund Commentary**

Ticker Symbol: Institutional Class WSVIX | **Q2 2021**

Environment

Transitory inflation. The phrase that defined the 2Q21 and continues to set the tone of the market today. The economy, as measured by GDP, is growing at a fast clip. Inflation is also growing at a fast clip. Even when adjusting for everything that economists like to adjust for, "core CPI" is at a higher level than we have experienced in over two decades. The answer is the same for the PPI inflation measurement. However, despite all of the statistical and anecdotal evidence of a growing inflationary backdrop of the US economy, Federal Reserve and Treasury officials, thus far, have successfully convinced the markets not to be concerned as they have argued that statistic calculations are being strongly affected by transitory issues.

Why is this important to small cap value investors? Previously we have written about the strong correlation between the 10-year US government bond yield and the Russell 2000 Value Index benchmark. When the yield is moving up, so do small cap equities. In general, when the economy is accelerating, bond yields go up. Additionally, and in general, when the market is anticipating inflation, bond yields go up. However, during the most recent quarter, despite accelerating inflation and GDP, bond yields fell significantly from 1.7% to 1.3%. This has had a challenging effect on our portfolio.

The consumer discretionary sector was one of the strongest sectors this past quarter as many of these companies are reporting strong results due to strong demand, as well as strong pricing and a lack of promotional selling. It is interesting that these companies are doing well because they are raising prices and don't need to put product on sale; sure sounds like inflation. We do not have a lot of exposure to this sector as we found it was difficult for us to model forward the margin expansion that many of these businesses are starting to achieve. Additionally, most looked to be way ahead of themselves on valuation. On the other hand, the financial sector, and banks in particular, are seeing their consensus earnings estimates moving upward and are telling us that they are seeing the initial signs of loan growth. This is also where we see the most attractive valuation opportunities. However, with rates dropping, investors were not interested in this sector which proved to be difficult for us as this is where the portfolio has its greatest exposure.

So where does this leave us? We believe that we will be working with an inflation rate that is a good bit higher than what we have experienced over the past decade. At some point, the market will recognize this and drop the transitory inflation model. Yields will rise and our financial services investments should be sought out by the market. All in all, it will be a strong environment for smaller US focused businesses.

One last word on inflation. We are speaking to management teams of portfolio holdings and new research efforts on a constant basis. Nearly all are telling the same story that supply chain challenges, the cost of raw materials, and the availability and cost of labor are their biggest challenges. When we ask about the opportunity to raise prices to meet these cost pressures, the consensus response is that raising prices is not a challenge. This is one of the stronger arguments supporting our current position on inflation.

Portfolio Performance

Portfolio Factors

The Fund underperformed the Russell 2000 Value Index by 320bps for the quarter. A review of the performance attribution reveals that two-thirds of the underperformance was due to sector allocation and one-third related to equity selection. Regarding sector allocation, being underweight Consumer Discretionary, Energy, and Real Estate, while overweight Financials were drags. Consumer discretionary names are performing well now, but we remain cautious with our positioning as we look out two years in the space, as margin performance and strong sales in the near term will likely not be sustained. Real estate performance improved as investors started to think more about rising interest rates. We remain bullish on our largest sector weighting, financials, as loan performance remains strong, and ample deposits represent a coiled spring. Once deployed as loans, we anticipate attractive earnings growth.

Stock Selection: Contributors

Our largest contributor in the quarter was Sanderson Farms (SAFM), a poultry company. The share price benefitted from reports that the company was exploring a sale. Industrial Logistics Property Trust (ILPT), a REIT of logistics properties, was the second largest contributor. We think investors are taking notice of the company's attractive property portfolio and changes to the leverage on the balance sheet through the strategic sale of some assets. Longer term e-commerce trends are a clear positive for the name. The three other top contributors were three of our community banks, Sterling Bancorp (STL), Hancock Whitney Corp (HWC), and PacWest Bancorp (PACW). These banks meet our criteria of well-run regional banks with attractive return outlooks given their ample lending capacity.

Portfolio Contributors – Q2 2021

Security	Average Weight (%)	Contribution
Sanderson Farms, Inc.	3.06	0.62
Industrial Logistics Properties Trust	2.61	0.34
Sterling Bancorp	1.97	0.30
Hancock Whitney Corp.	3.34	0.27
PacWest Bancorp	3.24	0.26

Stock Selection: Detractors

Independent Bank Corp (INBD), a Boston based bank, was the largest detractor from performance, with the underperformance being attributed to a lukewarm market response to the bank's announced acquisition of Rockland Trust. The strategy of the deal makes sense and accomplishes the following: furthers consolidation within the Boston market area; takes INDB through the $10B loan size; and presents clear earnings accretion. Casey's General Stores (CASY), a convenience store operator, reported earnings during the quarter and gave an outlook that did not provide much excitement to a market that is looking for robust growth. World Fuel Services (INT), a fuel distributor, underperformed despite underlying macro trends in their favor. We are seeing favorable fuel prices and a ramp up in airline flights, vehicle miles driven, and scheduled cruises, which will favor a company trading for around book value.

Portfolio Detractors – Q2 2021

Security	Average Weight (%)	Contribution
Independent Bank Corp.	2.87	-0.29
Columbia Banking System, Inc.	2.84	-0.28
Kirby Corp.	1.32	-0.27
Casey's General Stores, Inc.	2.66	-0.23
World Fuel Services Corp.	2.09	-0.23

Portfolio Changes and Positioning

We sold six positions out of the portfolio and added seven positions in the quarter. We moved on from two insurance names. The first was Essent Group (ESNT), which we had held through the recovery in the share price after COVID related weakness. We were correct that realized mortgage insurance losses related to COVID were low. Given our outlook for rising interest rates, the company's business would face a headwind. Our additions of new bank names Independent Bank Group (IBTX) and Eastern Bankshares (EBC) reflect this. Hanover Group Insurance (THG) was exited as well. We bought the name well and improved earnings resulted in a rapid achievement of our share price target, so we moved on. We continue to like the management and strategy they are pursuing. We also exited M.D.C. Holdings (MDC), a name that has performed well given the strong demand for housing. We felt that, based on past performance of homebuilders, we are entering a financial performance level where margins and sales levels cannot get any better. We are comfortable taking our profits and redeploying to better opportunities. Moog Inc (MOG-A) was sold as the name started to receive a better than warranted valuation from the improving outlook in air travel. Oshkosh Corp (OSK) was exited as the share price valuation recovered from COVID lows. Demand related to the aerial lift business was getting priced into the name and there was additional share price increase after the announcement of a less than certain USPS mail truck contract. Tapestry (TPR) experienced valuation expansion as reported results reflected the rebound of customer demand. Our price target was achieved and we moved on.

The additions of Eastern Bankshares and Independent Bank Group, mentioned above, fit into our successful community bank mold. Both exhibit good positioning in their markets, solid management teams, and an ability to grow lending organically while contemplating adjacent geographic acquisitions. Beacon Roofing Supply (BECN), a roofing materials distributor, was a name we had looked at before the COVID pandemic, but felt it was overleveraged. Coming out of the pandemic they made some meaningful changes. The company aggressively paid down debt with free cash flow and the sale of its interiors business. While the company does have exposure to new housing starts which have been improving, around 80% to 90% of the roofing business is replacement based, so we were attracted to the valuation of a much lower leveraged business with a consistent demand outlook. Granite Construction (GVA), is an engineering & construction firm that lost investor interest after missteps on some large projects and an accounting restatement. There have been management changes and troubled projects are more in the rearview. A focus on smaller projects, which the company has historically been proficient at, coupled with an attractive entry valuation, made us buyers. Kirby Corporation (KEX), an inland barge operator with a diesel engine service business, is a name that we exited early in the pandemic and monitored. Prior to the pandemic, we felt the company was on the cusp of recognizing multiple years of pricing improvement related to a variety of factors. The pandemic pushed many of these factors to the right, but did not eliminate them. We are seeing refinery utilization and chemical production coming back strongly. We see business outlook benefiting from Kirby’s continued consolidation of inland barge assets, charter prices improving (two competitors have gone bankrupt recently), and the elevated price of steel resulting in a very small industry order book for new tank barges, while at the same time increasing the scrapping of older vessels. Due to the bankruptcy of American Commercial Lines, there is only one remaining inland barge producer left, Arcosa (ACA). As a result, we can monitor new tank barge orders very closely. Ryder System (R) is an outsourced truck fleet operator, and leasing company. The company had been struggling with the performance of legacy leases (5 to 6 years in length) as truck residual values were weaker than expected years ago. Given the very strong recovery in US consumer demand, and issues with supply chains, demand for trucks has been very strong. Ryder is benefiting from improved economics on new leases being written today and improved recoveries on used trucks that are sold once old leases end. We are seeing a large change in return on invested capital results that we feel is sustainable. Chesapeake Energy Corporation (CHK), an exploration and production company which emerged from bankruptcy in February 2021. We are attracted to the post-bankruptcy balance sheet and a cash flow oriented management strategy.

We believe the portfolio is positioned to perform well given our economic outlook. We think inflation is real and not transitory, and that management teams need to be prepared to put pricing through to their customer and control costs. We also believe the yield curve will steepen over time and our banks are positioned to benefit, and will maintain their underwriting discipline.

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

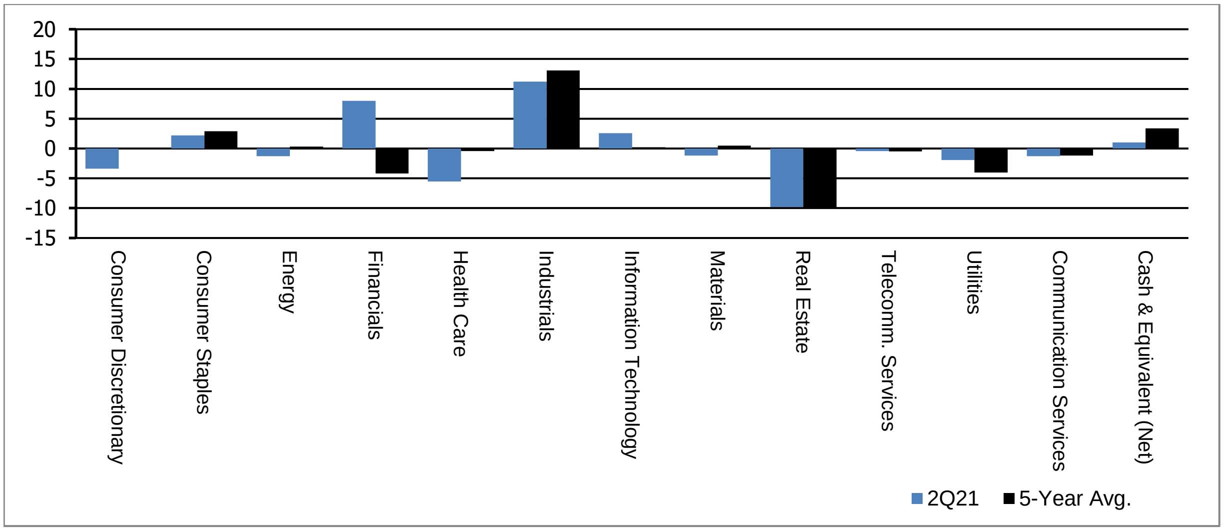

Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Top Ten Holdings (%)

Hancock Whitney Corp.	3.4
Wesbanco, Inc.	3.4
Sterling Bancorp	3.4
Hub group, Inc. Cl A	3.4
Concentrix Corporation	3.4
Cleveland-Cliffs, Inc.	3.2
ITT, Inc	3.1
Webster Financial Corp.	3.1
WSFS Financial Group	3.1
Triton International Ltd	3.0
Total % of Portfolio	32.5

Fund Characteristics

	Fund	Russell 2000 Value Index
Number of Holdings	38	1,384
Return on Equity[1]	2.7	-1.6
Weighted Avg Market Cap (Millions)	4,244	3,001
Price/Book[2]	1.7	1.6
P/E using FY1 Estimate[3]	13.3	14.3
Long Term Debt/Total Capitalization[4]	28.9	38.4
Information Ratio (TTM)[5]	.47	-
Active Share[6]	96.4	-

Source: Factset Research

Portfolio Performance

	Q2 21	1 Year	3 Year	5 Year	10 Year	Since Inception (12/27/10)
Walthausen Focused Small Cap Value Fund: Institutional Class	1.36	54.82	9.06	11.75	10.60	10.48
Russell 2000 Value Index[7]	4.56	73.28	10.27	13.62	10.85	10.60

Total Expense Ratio: 1.05%. Net Expense Ratio: 0.85%.
Expense ratio per the June 1, 2021 prospectus.

The Net Expense Ratio includes a waiver. The Advisor has contractually agreed to waive Services Agreement fees to the extent necessary to maintain total annual operating expenses of the Institutional 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 0.85% of its average daily net assets through October 31, 2025. The Advisor may not terminate the fee waiver before October 31, 2025. The Trustees may terminate the expense waiver upon notice to the Advisor. From the prospectus dated June 1, 2021.

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]*Return on Equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity. ROE is a measure of how effectively management is using a company's assets to create profits.*

[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.*

[4]*Long Term Debt/Total Capitalization is a ratio that measures the proportion of long term debt used to finance assets, as a percentage of the firm's total capitalization.*

[5]*The Information Ratio is a measurement of portfolio returns beyond the returns of a benchmark, in this case the Russell 2000 Value Index, compared to the volatility of those returns.*

[6]*Active Share is a measure of the percentage of portfolio holdings that differs from the benchmark index.*

[7]*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 values.*

[8]*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.*

[9]*The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index*

[10]*The Russell 2000® Growth Index measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000® companies with higher price-to-value ratios and higher forecasted growth values.*

[11]*Return on Assets is an indicator of how well a company utilizes its assets, by determining how profitable a company is relative to its total assets.*

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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Walthausen Funds
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