

## 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 that they persist, will likely constrain 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 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<sup>1</sup> 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 active managers 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 Select Value Fund we had a very disappointing year and the fourth quarter surge in the market did not help. We fell short of our benchmark, the Russell 2500 Value Index, both for the fourth quarter and full year.

We were very disappointed. We strive to provide consistent return while seeking to potentially avoid excessive risk. In our model we use forty well diversified<sup>2</sup> names and aim to keep about 80% of the weight in companies with strong business models which generate predictably strong returns on invested capital. The balance is invested in “special situation”, stocks where our analysis suggests that an improvement in returns and/or in the financial position seems reasonable in light of the fundamentals of the company and skill of the management team. These special situation stocks tend to be higher in risk and perform best in a rapidly expanding economy. While we are resolute in our skill in discovering special situations, we recognize that as the market weakens, our positions in stocks with more reliability have an opportunity to offset the risk associated with the special situations names.

This year our strategy did not work. We kept the special situations at close to 20% of the portfolio but for the year these names retarded our performance versus the benchmark. We learned some lessons about how treacherous the consumer marketplace has become in a digitally enabled world but took our losses and moved on. The big surprise was that the steady names, though they did well in building value for shareholders, were not recognized by the market. In the fourth quarter that shifted a bit and the special situations names did contribute but their 38 basis points contribution did not make up for the lackluster performance of our quality names. We dissected our performance versus the benchmark and observed that stocks in the index with a negative return on equity meaningfully outperformed stocks with a better than 12% return on equity. We were overweight in the high return on equity stocks and significantly underweight those with low to negative return on equity<sup>3</sup>. This confirmed that, as often happens when the bull market begins to age, speculation takes off. When we look at our performance we are very disappointed but know that we are not market seers and thus should not be tempted to shift from what has been a very steady performing strategy.

The allocation effect provided a modest negative with gains from our underweight to REITs but those gains were offset by our overweight to healthcare. In the fourth quarter, allocation helped again with a benefit from very low real estate exposure, as well as our overweight to Industrials. These benefits, however, were offset by selection disappointments.

### **Stock Selection: Contributors**

Stock selection hurt fourth quarter performance by 228 basis points. Contributions came from several very different holdings. GATX Corp. (GATX) was the best performer. This company is the leading leaser of rail cars. It is a tough business but GATX plays it very well. The company has in no way changed its stripes and though there are some significantly underappreciated assets in the company, we think that the great performance of the stock came from an acknowledgment that the economy was doing okay and that the company’s exposure to areas of weak rail traffic, coal and petroleum were pretty modest.

The second best performer was Commercial Metals (CMC). The company is an efficient steel maker, with operations from scrap to rebar fabrication. This was much more speculative. We are convinced that the company is methodically correcting self-inflicted wounds by exiting some bad international expansions and moving out of copper but the bigger question has been the outlook for rebar prices in the face of import competition and a slow construction market. The stock price suggested a lot of skepticism and the stock price improved with the FAST Act, better non-residential construction and progress in restoring reasonable prices to the market.

The third best contributor was Primerica (PRI). We have held this stock for a long time as the management team has rebuilt its book of small life insurance policies. During that time the stock has graduated from a fairly speculative spinoff to a solid company. We also throw the fourth best performer, Independent Bank (INDB), into the basket of solid companies. It enjoyed a good level of stock appreciation, in line with that of other solid banks.

The top five contributors were rounded out by SeaWorld (SEAS). We have believed that the new management team was making a solid turn around in this amusement park company and had been frustrated when, during 2016, attendance came under pressure from a stronger dollar and the fear of Zika. Both of these situations discouraged foreign visitors but as the year came to an end we began to see evidence that a shift in marketing is taking place and attendance is improving.

**Portfolio Contributors – Q4 2016**

| Security                      | Average Weight (%) | Contribution |
|-------------------------------|--------------------|--------------|
| GATX Corporation (GATX)       | 2.80               | 1.00         |
| Commercial Metals (CMC)       | 2.20               | 0.92         |
| Primerica, Inc. (PRI)         | 2.59               | 0.79         |
| Independent Bank Corp. (INDB) | 2.68               | 0.77         |
| SeaWorld Entertainment (SEAS) | 1.80               | 0.63         |

**Stock Selection: Detractors**

For the quarter the detractors came from diverse industries. The most painful was a drop in the price of Kindred Healthcare (KND) when the company announced that it was leaving the skilled nursing business. We applauded that move as that part of the operation was not very profitable and the payers were steadily pushing for shorter stays and more home healthcare. Though our holding in Kindred has thus far not been rewarding, we are convinced that they are well positioned and that management is making the correct moves.

Our second detractor on the quarter was Pitney Bowes (PBI). The highly lucrative mailing systems business is under some pressure from declining use of the mail but we knew that when we added the position. We felt that with the steady level of revenues, they had enough room to keep costs going down at a steady rate and an ability to redirect resources into new but related ventures. We were disappointed by the execution and have sold the position.

We were also hurt by poor stock performance on the part of three very high quality enterprises, VWR Corp. (VWR), Avery Dennison (AVY) and Graphic Packaging (GPK). To some extent a stronger dollar may have hurt the performance of these stocks but we think that a solid global presence is a plus. The reduced profits due to the effect of translating results are offset by the benefit from the lower costs of being in a weak currency country. We continue to hold these stocks.

**Portfolio Detractors – Q4 2016**

| Security                  | Average Weight (%) | Contribution |
|---------------------------|--------------------|--------------|
| Kindred Healthcare (KND)  | 2.61               | -0.49        |
| Pitney Bowes (PBI)        | 1.78               | -0.39        |
| VWR Corp. (VWR)           | 2.46               | -0.34        |
| Avery Dennison Corp (AVY) | 2.47               | -0.27        |
| Graphic Packaging (GPK)   | 2.18               | -0.25        |

**Portfolio Changes**

During the quarter we were relatively quiet selling only two positions. We exited Restoration Hardware (RH) with a small gain and great uncertainty about how well management is executing its' business plan. We also sold Jabil Circuit (JBL) with a moderate gain. We feel this stock had achieved reasonable price gains for the short term and that the risks regarding the longer term outlook were not warranted.

We added two positions. We see Graphic Packaging Holdings (GPK) as a very solid and steady packing company with a specialty in making the cardboard packing for beer and soft drinks. They are efficient and able to grow moderately over time. The stock was under some currency pressure as well as a temporary slowdown with some customers.

We also added Firstcash (FCFS) a major pawn broker. We believe that for many lower income families the services of pawn brokers are a substitute for the banking services which are not available to them. The fundamentals of the business, their secured small loans, are solid and reliable and we consider that the company will likely prosper in good and bad economies.

**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; that, 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 2500 Value Index

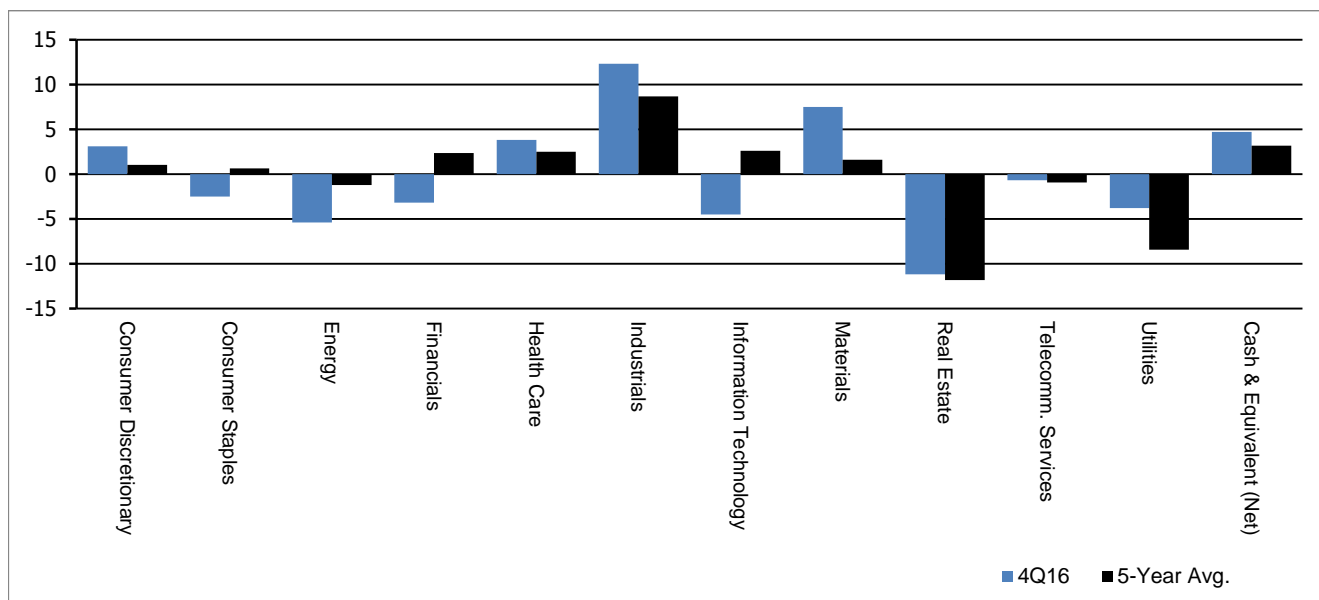


Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2500 Value Index benchmark have not changed greatly from today's levels versus the five year average.

### Top Ten Holdings (%)

|                           |      |
|---------------------------|------|
| Kindred Healthcare, Inc.  | 3.0  |
| Outfront Media, Inc.      | 2.9  |
| Essent Group Ltd.         | 2.9  |
| Horace Mann Educators     | 2.8  |
| Snap-On, Inc.             | 2.7  |
| Suburban Propane Partners | 2.7  |
| HealthSouth Corp.         | 2.7  |
| MDC Holdings, Inc.        | 2.7  |
| American Financial Group  | 2.7  |
| Deluxe Corp.              | 2.6  |
| Total % of Portfolio      | 27.7 |

### Fund Statistics

|                                     | Fund      | Russell 2500 Value Index |
|-------------------------------------|-----------|--------------------------|
| Number of Holdings                  | 39        | 1725                     |
| Median Market Cap (Billions)        | \$3,096.0 | \$1,030.1                |
| Weighted Avg. Market Cap (Billions) | \$3,464.3 | \$4,129.0                |
| Price/Book <sup>4</sup>             | 1.9       | 1.6                      |
| P/E using FY1 Estimate <sup>5</sup> | 17.8      | 18.3                     |

Source: FactSet Research

## Portfolio Performance

|  | Q4 16 | 1 Year | 3 Year | 5 Year | Since Inception<br>(12/27/10) |
|--|-------|--------|--------|--------|-------------------------------|
| <b>Walthausen Select Value Fund: Institutional Class</b> | 7.89  | 14.42  | 2.74   | 13.38  | 10.41                         |
| <b>Walthausen Select Value Fund: Retail Class</b>        | 7.88  | 14.08  | 2.50   | 13.10  | 10.13                         |
| <b>Russell 2500 Value Index<sup>6</sup></b>              | 9.34  | 25.20  | 8.22   | 15.04  | 11.67                         |

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.

<sup>6</sup>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

<sup>1</sup>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.

<sup>2</sup>Diversification does not ensure a profit or guarantee against loss. Past Performance is no guarantee of future results.

<sup>3</sup>Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

<sup>4</sup>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.

<sup>5</sup>P/E using FYI 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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