# Walthausen Small Cap Value Fund

Quarterly **Fund Commentary**

**Ticker Symbol: WSCVX** | **As of March 31, 2018**

## Environment

The first quarter could be a sign of things to come. Stocks showed vulnerability for the first time in quite a while. Most interestingly, investors began selling the stocks that have been leading the market higher over the past several years. We have been commenting consistently for several quarters on the eerily consistent appreciation of the US equity markets which continued through January. Volatility returned in force during February and March and it seems like investor complacency has been disrupted which could make this year much more challenging.

Much has been said about market leadership. For a period now approaching ten years, growth investing has been driving the market higher and the leadership during the past couple of years has been clustered around a narrow group of sectors and stocks. This has led to an even greater concentration of market capitalization within this group which exacerbates the movements of most market cap weighted indices. Today, Technology, Financials and Health Care collectively make up the majority of the total US equity market. We are beginning to see that the trust people have placed in certain technology firms is waning as people recognize that these firm's ownership of so much information could lead to potentially dangerous outcomes. A shift in investor sentiment, if and when it occurs, may result in these high flyers falling to more earthly valuations, and in the process will damage the market cap weighted indices. This may make these instruments more vulnerable than we believe some investors realize.

All of this puts small cap value stocks in an interesting position. At this point, the economy seems to be buzzing along well. Employment is healthy, taxes are a bit lighter for most Americans, and wages are rising. Looking further into 2018, we expect that small cap company profits will grow well, even before we consider the positive impact of lower tax rates and changes that will encourage investing in capital projects; two factors that bode well for the companies we like to own. The recent trade tariffs are, at this point, largely inconsequential to the companies we hold and rising interest rates are not a current concern as we favor companies that typically have good to improving cash flow, thus diminishing their sensitivity to capital markets and rising rates.

Although the number of candidates has gotten fewer and our process of selection has gotten tighter, we continue to find attractive companies that possess good to improving return on invested capital with good cash flow. This is partly attributable to the fact that small cap value has lagged growth considerably over the recent years and that, as of the writing of this commentary, the market has narrowed as new 52 week highs are losing ground to new lows. In this, we see a hint of where a hoard of new value stocks may come from.

We maintain our cautious optimism and feel comfortable with the holdings in our portfolios as they represent a diversified group of fundamentally strong companies that, in our opinion, are poised to perform well on a relative basis whether this past quarter becomes something more, or if the march onward and upward continues.

## Performance Review

### Portfolio Factors

The Small Cap Value strategy performed well on a relative basis, versus the Russell 2000 Value Index.

For the quarter, the benchmark's Health Care sector was the only real winner, with Financials a distant second. The strategy suffered from an underrepresentation in Health Care but fortunately our sole holding, Addus Healthcare (ADUS), did quite well. We were also a bit underweight in Financials but favorable selection offset the issue there as well.

The worst performing sector in the index was Energy. We were close to fully weighted there and our selections fared a bit worse than the sector at large due primarily to the underperformance attributed to Halcon Resources (HK). As rates went higher in the quarter, the yield stocks (Telecommunications, Utilities and Real Estate) all did poorly. Consistent with our positioning, we were almost entirely absent these groups.

### Stock Selection: Contributors

We had already mentioned Addus Homecare (ADUS). The stock did particularly well as their Q4 2017 report gave investors comfort in how well managed the company is. We also scored a pleasing gain with auto parts maker Stoneridge (SRI), where we spotted a business mix that had become much richer in proprietary technology. We also did well with the market's increasing recognition of the improving fundamentals of First Cash (FCFS), Navigators Group (NAVG), and McGrath RentCorp (MGRC).

There was one buy out during the quarter; Ply Gem Holdings (PGEM). They are a maker of vinyl siding, windows and doors for single family residences. They were profiting from the gradual improvement in home building but the stock was languishing due to its inability to improve margins. We were becoming discouraged but a private equity group emerged and negotiated a purchase at a modest premium. With the exception of Ply Gem, we have retained positions in all of our top ten performers.

**Portfolio Contributors – Q1 2018**

| Security | Average Weight (%) | Contribution |
|---|---|---|
| Addus HealthCare Corp. (ADUS) | 1.16 | 0.47 |
| Stoneridge, Inc. (SRI) | 1.85 | 0.37 |
| FirstCash, Inc. (FCFS) | 1.79 | 0.33 |
| Navigators Group, Inc. (NAVG) | 1.59 | 0.28 |
| McGrath Rentcorp (MGRC) | 1.99 | 0.28 |

**Stock Selection: Detractors**

Our most difficult stock was Halcon Resources (HK), a Permian basin oil producer. Though we think the company should have been more cautious in land acquisition, we continue to hold the stock as we believe there is substantial value yet to be recognized. We had done very well with Winnebago Industries (WGO) and took some gains last year. The stock retreated in the first quarter on anxiety that the resurgence in sales of recreational vehicles is coming to an end. We are sticking with our position as we believe the management team has the right strategy. We also saw price declines at Rogers Corp (ROG), which like Winnebago, was one of the best performing stocks in Q4 2017. We had taken some profits and are weighing the balance of the position in the face of some uncertainty about the current year. CSS Industries (CSS) and Masonite (DOOR) also disappointed. In both cases the price drop related to below expectation Q4 2017 reports. We have maintained our position in both of these stocks.

**Portfolio Detractors – Q1 2018**

| Security | Average Weight (%) | Contribution |
|---|---|---|
| Halcon Resources Corp. (HK) | 1.49 | -0.52 |
| Winnebago Industries (WGO) | 1.24 | -0.43 |
| Rogers Corp. (ROG) | 1.47 | -0.43 |
| CSS Industries, Inc. (CSS) | 0.86 | -0.40 |
| Masonite Corp. (DOOR) | 1.11 | -0.26 |

## Portfolio Changes

In the first quarter we added five new stocks replacing eight other positions. The additions represent a diverse group of industries but in each case we see reason to expect improving results, contrasted against a moderate valuation. The additions include Esterline (ESL), an aerospace supplier which has had some disappointing performance but now with a small disposition of a facility and some management changes we think earnings will improve. We also added Keane (FRAC), a provider of fracking services in the domestic oilfields. As drilling techniques become more sophisticated, the demand for fracking services is outstripping supply. We also added Global Brass (BRSS), and Masonite (DOOR).

We sold seven stocks. In the cases of Dana Corp (DAN), AAR Corp. (AIR), and Greenbrier (GBX), we exited when they achieved their anticipated appreciation. Vista Outdoor (VSTO) was more complicated. Although the core hunting rifles and ammunition segments appear likely to rebound, the shifting environment regarding gun sales, and an overleveraged position, degraded our thesis and we exited the position. Likewise, we exited Primoris Services (PRIM) when they moved forward with an acquisition which we judged to be unwise. We had already mentioned the acquisition agreement for Ply Gem. Finally, we exited two small positions in Overseas Shipholding (OSG) and Dorian LPG Ltd. (LPG). The latter had been acquired as a dividend from our position in SEACOR Holdings (CHK).

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

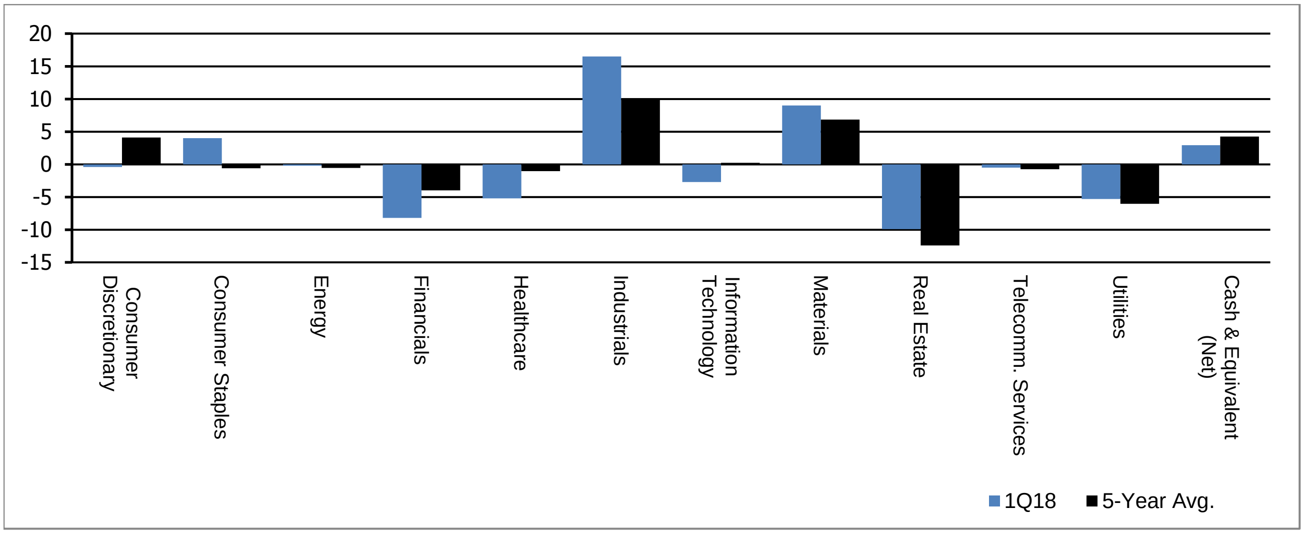


Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

### Top Ten Holdings (%)

| | |
|---|---|
| McGrath Rentcorp | 2.0 |
| FirstCash Inc. | 2.0 |
| Heritage Crystal Clean Inc. | 2.0 |
| SEACOR Holdings Inc. | 2.0 |
| Unifi Inc. | 2.0 |
| Stoneridge Inc. | 2.0 |
| Interface Inc. | 2.0 |
| Primerica Inc. | 1.9 |
| M/I Homes Inc. | 1.8 |
| Navigators Group Inc. | 1.8 |
| Total % of Portfolio | 19.5 |

| Fund Statistics | | Russell 2000 Value Index |
|---|---|---|
| Number of Holdings | 76 | 1,398 |
| Median Market Cap (Millions) | $1,070.8 | $726.9 |
| Weighted Avg. Market Cap ( Millions) | $1,379.0 | $2,018.1 |
| Price/Book[1] | 1.7 | 1.4 |
| P/E using FY1 Estimate[2] | 15.2 | 15.4 |

## Portfolio Performance

| | Q1 18 | 1 Year | 3 Year | 5 Year | Since Inception (2/1/08) |
|---|---|---|---|---|---|
| **Walthausen Small Cap Value Fund** | -2.07 | 10.26 | 7.27 | 9.48 | 13.03 |
| **Russell 2000 Value Index[3]** | -2.64 | 5.13 | 7.87 | 9.96 | 7.98 |

*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.*

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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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