Walthausen Small Cap Value Fund

Quarterly **Fund Commentary**

Ticker Symbols: Institutional Class WFICX | Investor Class WSCVX

As of June 30, 2019

Environment

Three months ago I expanded on the astounding divergence of the performance of growth and value. That gap closed a bit in the second quarter but it remained meaningful, with the Russell 2000 Growth Index 137 basis points ahead of the Russell 2000 Value Index. The duration of this trend is disconcerting for value investors. Ten year annualized returns for the growth and value indices show a 200 basis point gap in favor of the small growth stocks. That triumph of growth comes mostly over the past three years but it is extraordinarily large and surprisingly durable. This makes me wonder, is growth the new paradigm and will the "old economy" die? We have heard "this time it is different" a good number of times. Always it has turned out that the economy was only evolving.

What is causing this disparity of performance between growth and value stocks? It is hard to know as the economy and the market contain so many variables that any observation can never rise beyond the status of thesis. Our thought is that it's the sustained low interest rate, with 10 year treasuries near the level of inflation. The cost of capital, and therefore the discount rate that is used to value any security, has fallen dramatically. Now it is just a thesis but it is one of the few that can explicate the high valuations accorded to growth companies with rapid revenue growth, current losses and the promise of massive earnings far in the future.

But this is just a thesis. If the time value of money is so little, why do most domestic energy stocks trade at a discount to their PV10 value? That calculation uses current oil and natural gas prices to discount the value of what the company may reasonably bring into production over the next five years using a 10% discount rate. And why have stocks of profitable, well financed dividend paying companies languished. Is this a case of too much money chasing a good idea? Is it similar to the dot com bubble? Is the rush of IPOs by venture capital backed startups a sign that smart money knows that the "Unicorn" game is about played out?

The good news is that while we, as value investors, have lost ground relatively, the companies that we invest in are generally doing well, generating healthy returns on capital and reinvesting for growth and good returns on capital. They appear well positioned to do that in the foreseeable future.

Performance Review

Portfolio Factors

The market for domestic small cap value stocks, as measured by the Russell 2000 Value Index, was pretty quiet with the benchmark gaining only slightly, well below the larger value stocks, as measured by the Russell 1000 Value Index, and well behind larger growth stocks. No excessive investor enthusiasm was noted. We were able to achieve a gain, insubstantial but still a gain. This was largely achieved through fortuitous sector positioning. For example, the best performing benchmark sector was the Industrials where the benchmark was up 7.28% and our overweight position helped. We were a bit too cautious in our selections but still the sector added 103 basis points to returns, which was gratifying as we have seen better value opportunities in that sector than in others. We also gained where we were light in weight. The Healthcare sector, which had been performing well in past quarters, fell 5.03% and we benefited from only a small exposure. We entered the quarter with no holdings but found Allscripts Healthcare (MDRX), a practice management software business, which did well. In total, Healthcare added 48 basis points.

We were penalized modestly by our absence from Utilities and hurt by an over exposure to Consumer Discretionary and Consumer Staples sectors.

Stock Selection: Contributors

Our largest contributors included two companies that are being acquired – Electronics for Imaging (EFII) and Global Brass and Copper (BRSS). The three other holdings which round out the top five contributors share a common attribute. Changes in top management are resulting in better margins and sustainable earnings gains. Great Lakes Dredge & Dock (GLDD) is a major provider of harbor dredging and shoreline restoration. Demand is good and supply is constrained by the requirement that only US built boats can do this work. The current management is doing a better job of managing its assets and is more careful in its bidding. SeaWorld Entertainment (SEAS), an amusement park operator, has retired the controversial whale performances and have invested in new attractions, revised pricing and done a better job on managing expenses. We were early but are being rewarded now. Columbus McKinnon (CMCO) is a leading maker of industrial hoists and other material handling equipment. It has been well managed but the new team has improved upon its history by successfully implementing a number of effective cost reduction/value adding strategies and earnings are coming through surprisingly well. We are maintaining our positions in all three holdings.

Portfolio Contributors – Q2 2019

Security	Average Weight (%)	Contribution
Quad/Graphics	1.71	-0.63
Landec Corp.	2.07	-0.54
Gulfport Energy Corp.	1.04	-0.53
SilverBow Resources	0.85	-0.46

Stock Selection: Detractors

Our five largest detractors included two exploration and production companies, both of which are focused on natural gas production. We are positive on the longer term outlook for natural gas as the world demand for liquefied natural gas is growing as part of the global transition from coal to more environmentally friendly sources of energy. However, for the moment ample supplies of gas have brought down natural gas prices. Our worst performer was Quad/Graphics (QUAD), a printer specializing in magazines, circulars and catalogs. The market, particularly for magazine printing, is shrinking. Quad has generally maintained margins by aggressive use of lean processes and by consolidating into giant one million square foot facilities, as well as periodic acquisitions of struggling competitors. The past months have been devoted to acquiring an underperforming competitor, LSC Communications (LKSD). This acquisition was approved by the shareholders of both companies but the Justice Department has sued to prevent it. While this was going on, Quad has held back from the usual plant consolidation and overhead reductions. We wonder about the Justice Department’s rationale since the customers are very big and powerful and would not seem to need the protection, but this setback does challenge our investment thesis.

Another holding which seems to be facing a difficult situation is Sally Beauty Holdings (SBH). This retailer/supplier of hair care products to professional hair stylists, has been under some pressure from a changing competitive environment. They have traditionally depended heavily on creative suppliers who wish to support the hair stylist with “professional only” products. Sally seems to have been facing increasing competition from products available on the internet. The company has taken several strong actions to make their stores more attractive and to build a stronger bond with the customers. However, we understand that Amazon is targeting the hair stylists with a special rapid delivery service. It is too early to know the impact, but Amazon’s infrastructure, sophisticated systems and willingness to operate with thinner mark ups does challenge our investment thesis.

The five underperformers is rounded out with Landec (LNDC). This is a company that we are quite enthusiastic about and believe that the outlook is much stronger than the market credits. The company has two segments, a packaged natural foods business and a specialty chemicals business for the pharmaceuticals industry. The food business has had its challenges. The market potential is there but execution has been wanting. The specialty chemical business is quite profitable and on the verge of seeing rapid growth as an expanded facility is filled with new business. We like the recent CEO change as we foresee the focus to be much more on execution over strategic growth.

Portfolio Detractors – Q2 2019

Security	Average Weight (%)	Contribution
Electronics For Imaging	0.80	0.57
Great Lakes Dredge and Dock	2.29	0.47
SeaWorld Entertainment	2.41	0.46
Global Brass and Copper	2.09	0.45
Columbus McKinnon Corp	1.87	0.41

Portfolio Changes

We saw typical level of changes in the portfolio during the second quarter with the sale of eight stocks and the purchase of eight. We sold Electronics for Imaging after they agreed to be acquired. The stock traded to a premium to the takeover bid. We analyzed the situation and concluded that a competing bid was not likely and sold our holdings. We are concerned about the ramifications of Boeing's problems with the 737 MAX planes and sold two stocks where that program was large for them (Kaiser Aluminum (KLAC) and Triumph Group (TGI)). We sold Triton International (TRTN), a container leasing company, because of signs that international trade is weakening. We sold Southside Bancshares (SBSI) to replace it with a more promising bank. We sold three other industrial stocks to shift to better opportunities; Ampco-Pittsburgh (AP), Standex International (SXI), and EnPro Industries (NPO).

Several stocks that we added during the quarter have done well. AAR Corp (AIR), a supplier of parts and maintenance services to the airlines and armed forces, had a much better than expected fourth fiscal quarter. Allscripts Healthcare (MDRX), a software provider to medical practices has done a better job of explaining their strategies. Dycom Industries (DY), a maintenance contractor for telecoms and utilities, reported a good quarter as well. Several other stocks which we acquired have languished. Stewart Information Services (STC), a title insurance company, is almost certainly benefiting from the recent pick up in home sales but the stock has yet to budge. Mobile Mini (MINI), a lessor of the steel boxes which are used for temporary storage, has substantially improved their operating systems and will do well with the economy still growing, but the stock is flat. First Bancorp (FBNC), a North Carolina Bank, has yet to see any price movement. Haynes International (HAYN), a specialty steel maker, has seen the stock slide a bit since acquired. We think with some major capital upgrades behind them, the new CEO could well be reporting encouraging results in the next few quarters. Penn Virginia Corp (PVA), an exploration & production company, was the most disappointing of our recent stock buys. The stock has subsided with the erosion of petroleum prices.

Portfolio Positioning

We are pleased with where the portfolio is positioned today. With the exception of P/B, our portfolio is at or below the benchmark in each pertinent valuation metric. The return metrics of our companies, as measured by ROA and ROE and historic eps growth, was meaningfully above the comparable average of the benchmarks.

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

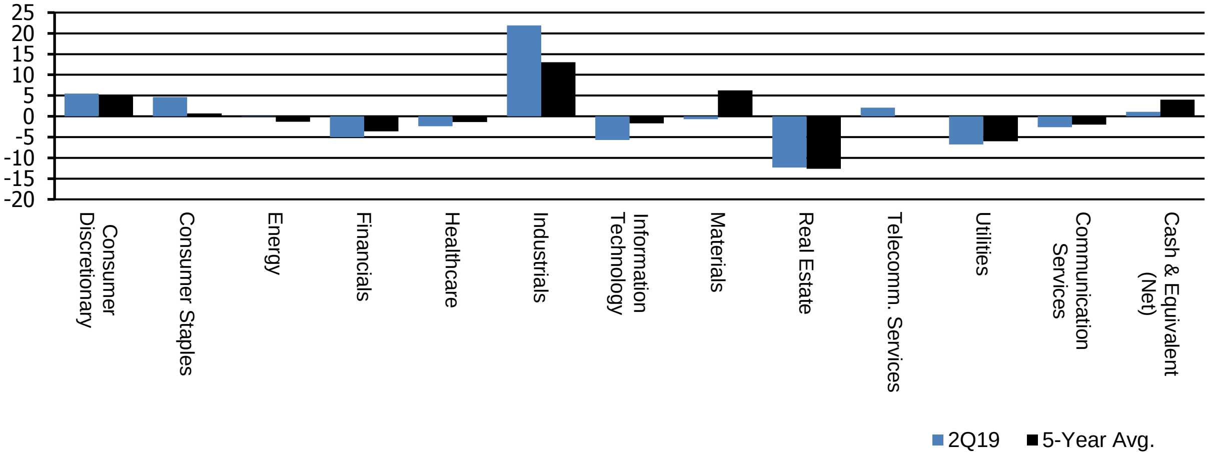

Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Top Ten Holdings (%)

Seaworld Entertainment, Inc.	3.0
Primerica, Inc.	2.5
Great Lakes Dredge & Dock Corporation	2.5
MGP Ingredients, Inc.	2.5
Meredith Corp.	2.4
Columbus McKinnon Corp.	2.4
Global Brass and Copper Holdings, Inc.	2.3
ABM Industries, Inc.	2.2
McGrath RentCorp.	2.2
M/I Homes, Inc.	2.1
Total % of Portfolio	24.1

Fund Statistics

	Fund	Russell 2000 Value Index
Number of Holdings	70	1,347
Median Market Cap (Millions)	$1,105.8	$696.0
Weighted Avg. Market Cap (Millions)	$1,459.6	$2,186.2
Price/Book[1]	1.6	1.4
P/E using FY1 Estimate[2]	12.9	14.1

Source: FactSet Research

Portfolio Performance

	Q2 19	1 Year	3 Year	5 Year	10 Year	Since Inception	Inception Date
Walthausen Small Cap Value Fund: Investor Cl	1.06	-8.74	8.41	2.66	14.71	10.91	2/01/08
Russell 2000 Value Index[1]	1.38	-6.24	9.81	5.39	12.40	7.22	
Walthausen Small Cap Value Fund: Institutional Cl	1.12					13.64	12/31/18
Russell 2000 Value Index[1]	1.38					13.47	

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.

The Russell 1000® Value Index measures the performance of the large cap value segment of the US. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth sales.

Return on Assets (ROA) is a profitability ratio that indicates how profitable a company is relative to its total assets.

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.

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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