Walthausen Focused Small Cap Value Fund

Quarterly **Fund Commentary**

Ticker Symbol: Institutional Class WSVIX | **Q4 2021**

Environment

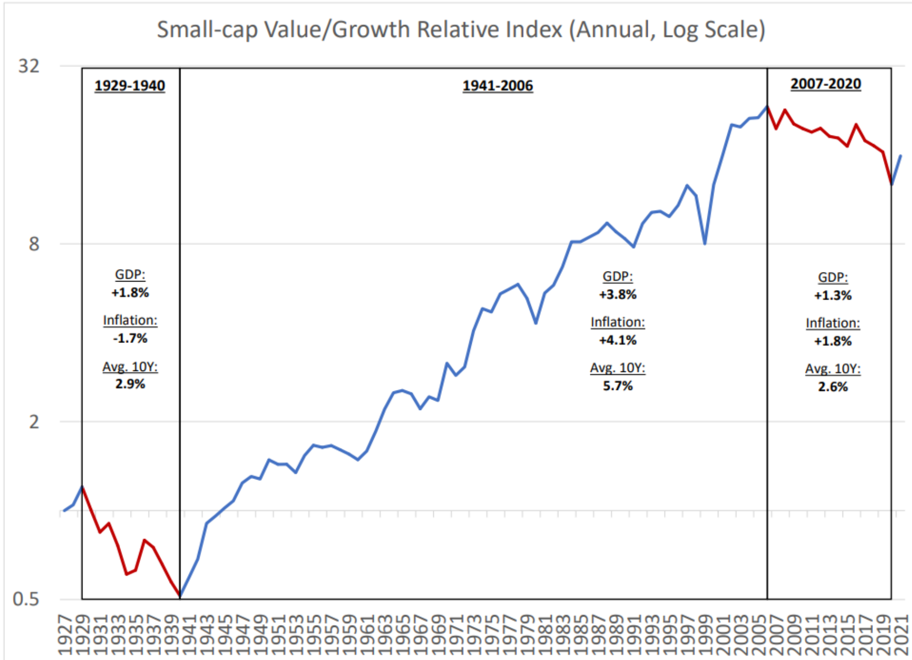
I am proud to say that 2021 was a good year for Walthausen & Co., with two of our three strategies beating their primary benchmark and our third missing out to its primary but beating its secondary benchmark. I am proud because at the mid-way point, it did not appear that success would be ours. We noted in the third quarter review that despite the benchmarks having been in a several month trading range, there were significant changes taking place. The most important being that companies bearing the markers often associated with "quality" (profitable, low volatility, dividend growth, high returns) were outperforming those that are most often categorized by more questionable traits (unprofitable, low ROE, highly shorted, high variability). To those of us that have been educated in the school of fundamental investing, it is accepted as a given that over time the higher returning, higher profitability company would produce the better investment return. However, for a long time that has not been a given.

At this year's halfway point, our Small Cap Value strategy was ahead of its benchmark by a respectable margin; however, our Focused Small Cap Value strategy and our Micro Cap Value Strategy were trailing by over 600 and 1200 basis points respectively. Trying to make up differentials of that degree is a mighty challenge. Asking to make it up in six months is out of the question. The Focused Small Cap Value strategy made up more than 500 basis points of its differential while the Micro Cap Value made up all of its differential and then some. How did this happen?

In the third quarter commentary we wrote, *"So, at least for a quarter it seems that fundamentals matter again. And as I stated in a recent client meeting, we feel like we're in a fair fight again"*. The fight remained fair throughout the fourth quarter, and we have always liked our chances in a fair fight. In a market where fundamentals and identifying companies poised to perform the best matters, we are happy to put ourselves up against the finest.

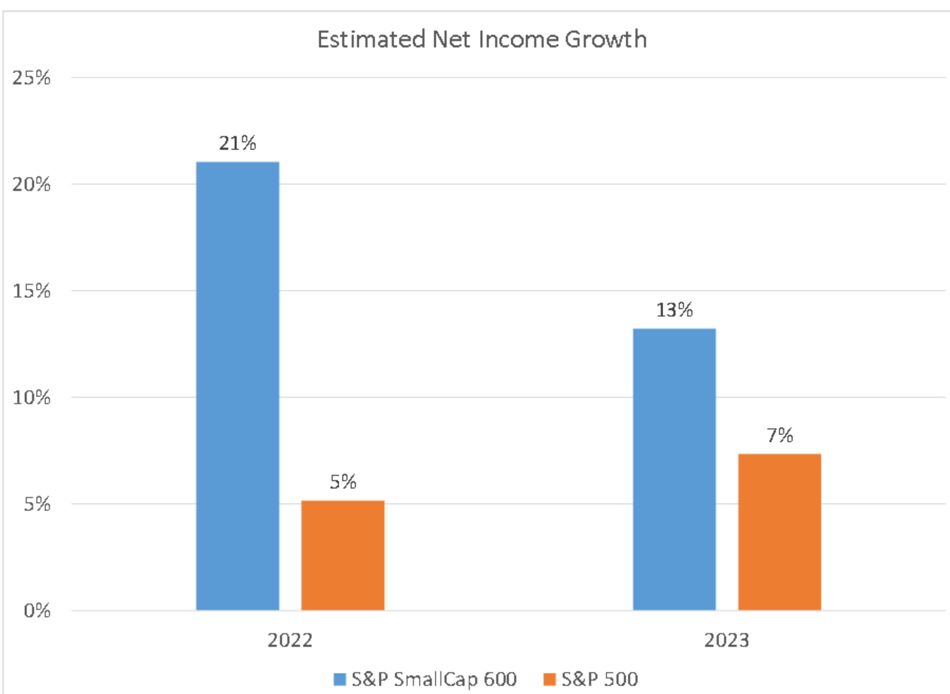
While the 2021 performance has us excited, we are even more excited for the future. The past decade has been an extended period of large cap equity performance beating small caps. It's been a period of growth investing beating value investing. The low GDP, low inflation, low interest rate environment of the past decade supported these results. Many talking heads have spoken to value investing making a comeback during the pandemic and small caps having moments of glory. We believe they are missing the bigger picture: that the pandemic changed both the way the public thinks and the resulting economic environment ahead which should be much more favorable for small caps and value strategies.

The pandemic's effect on the public psyche and the economy will be enduring. "COVID Consciousness" and "The Great Resignation" are two sides of the same coin. The public (the consumer) is going to make spending decisions that are definably different than those made of the past decade. Similarly, the workforce will be making decisions that are definably different than the past decade. Specifically, the work force will be demanding better work conditions, benefits, and pay. Compensation expense will grow at an annual rate that is significantly higher than what has been experienced in the past decade and this will flow through to inflation: not an extreme level of inflation, but an increase from the levels seen during that past decade. As we have discussed in previous missives, a higher inflation rate environment favors value investing.

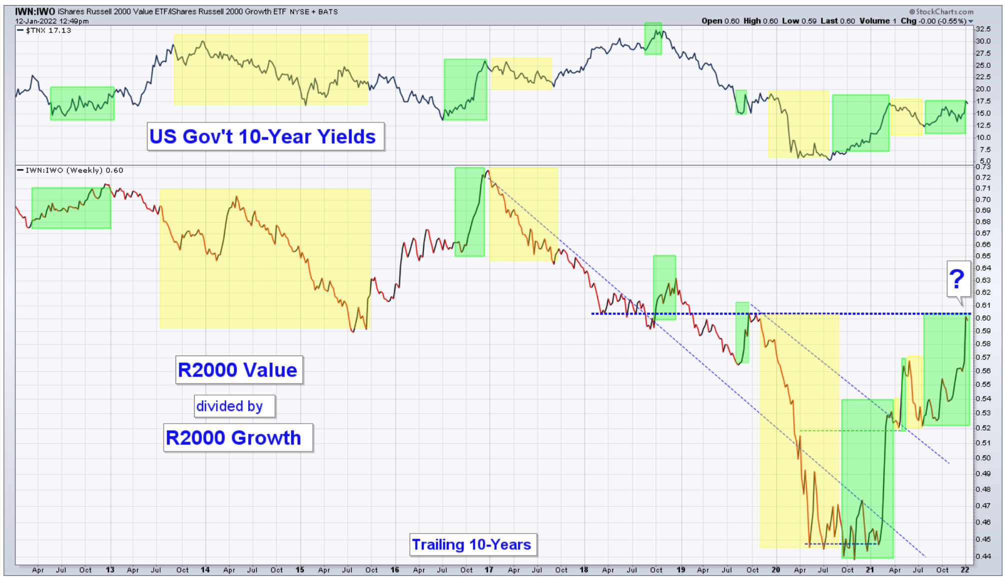


Source: FRP, FactSet, Morningstar; as of 12/31/21

With higher GDP and inflation comes pricing power. With pricing power comes margin support and earnings growth. One of the most basic beliefs of the fundamental investor is that stock prices follow earnings growth. For the past decade, large cap companies have had a higher earnings growth rate than small caps. As seen below, a reversal is forecasted with the growth of earnings of small caps expected to significantly outperform that of large caps.

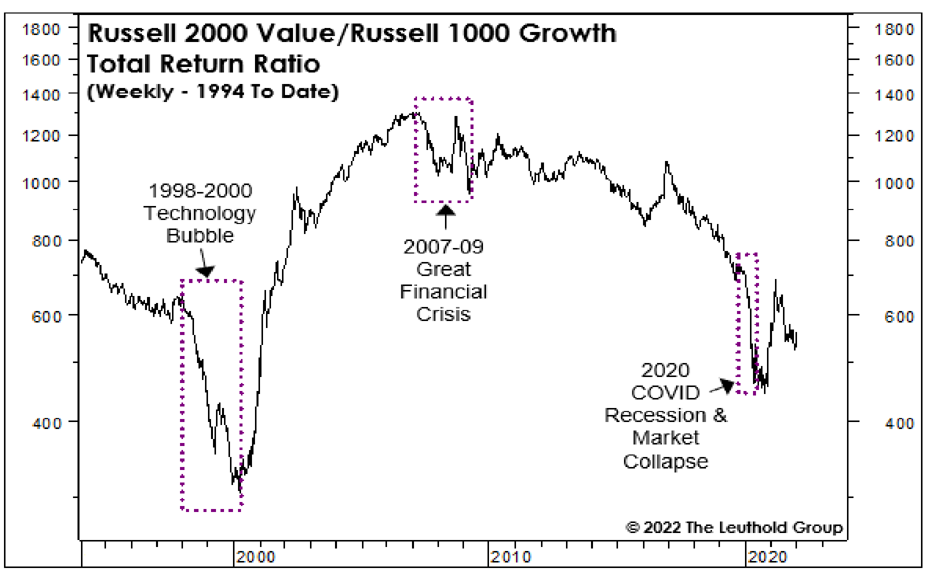


Additionally, with modest inflation and stronger earnings, we should also expect increasing interest rates. Generally speaking, over the past decade we see a pretty strong correlation between periods of rising 10-year treasury yields and value investing outperformance.



Source: Furey Research Partners and StockCharts.com

Major market inflections - messy though they may be - can have a long-term effect on how the market goes about its business. It's easy to talk about but more powerful to see. Look at how the market, significantly small value, outperformed large growth after the Dot Com Bubble. And small value kept on winning right up until the Great Financial Crisis. The inflection was messy but for the next decade large growth's outperformance continued unabated. We contend that the pandemic is as significant of an economic and public psyche event as these previous events and that a change of leadership is upon us.



Source: Chart courtesy of The Leuthold Group

Putting this all together one begins to see why we are so excited about the future. There are indications that quality and fundamentals are starting to mean more to investors again. We see signs that the economic backdrop, be it GDP, inflation or interest rates, are coming together in a way that has historically been quite favorable to the small cap value investing style. Current earnings growth estimates favor our small and micro cap companies. These are all important attributes of an investment environment that can be quite favorable to us. It looks like we are back to a fair fight.

Performance

During the 4Q21, the Focused SCV Fund generated a return of 176 basis points in excess of the Russell 2000 Value Index benchmark. We were pleased to see around two thirds of our outperformance was related to stock selection. Our selections in Industrials, Consumer Discretionary, and Materials were the largest contributors to the outperformance, while our selections in Financials and Real Estate were our laggards.

Within the Industrial sector the favorable contributions came from a variety of companies: Mueller Industries (MLI), a value added metals processing company, Kirby Corp (KEX), a barge operator & diesel engine servicer, Hub Group (HUBG), a logistics company, and Beacon Roofing Supply (BECN), a roofing products distributor. Common themes from these investments are recovery of the US economy, pricing power in excess of inflation, and strong/improving balance sheets.

The Consumer Discretionary sector benefit was largely from Cavco Industries (CVCO), a manufactured housing ("MH") company. The firm has followed the MH industry closely for over a decade. While there have been many articles written about lumber pricing and the rising cost of median home transactions, we felt that investors were missing the work that many manufactured home companies were doing to improve their operations and provide truly affordable housing to US home buyers. As sales performance of Cavco has improved, the market is starting to take notice. With the Cavco's average home price well below the US median home price, the company is taking share from stick built competition. We believe that the company's sales will remain elevated for at least the next few years.

Materials sector benefit came from Valvoline (VVV), a vehicle service & lubricants company, and Cleveland Cliffs (CLF), a steel producer. Ashland Chemical (ASH) spun off Valvoline in 2017. Since the spin off , the company has taken free cash flow that was previously sent to Ashland corporate, and refocused it on organic and inorganic growth of the Valvoline vehicle service business. Based on our analysis, the Valvoline vehicle service business is one of the fastest growing 4 wall concepts in the US. In October 2021, the company disclosed that it will pursue a separation of the service business from the global services segment (primarily lubricants). We believe the market is starting to better understand the growth potential of the retail services business and valuing it more like growth company. Cleveland Cliffs share price benefitted during the quarter from the better understanding of the massive change that Cleveland Cliffs made in to their business in 2020 through the acquisitions of both AK Steel and ArcelorMittal's USA assets. The company continues to be well positioned heading into 2022; the Biden Administration is maintaining import tariffs on Chinese steel, US auto manufacturing is forecast to rebound strongly, and we should start to see some impact from infrastructure spend. Given Cleveland Cliff's vertical integration strategy and the elevated price of scrap steel, the company is currently a low cost producer in the US.

Top Contributors

Top contributing positions in the quarter were Cavco Industries, discussed above, benefiting from increased sales and margins, Mueller Industries, discussed above, benefiting from increased sales and very strong margins. Onto Innovation (ONTO), an inspection, metrology, and lithography company servicing the semiconductor manufacturing industry, is benefiting from strong sales growth and margin improvement as the company manufactures equipment that will aid semiconductor fabs in increasing their production output going forward.

Top Detractors

The largest detractors were World Fuel Services (INT) discussed below, Encompass Health Services (EHC) and operator of inpatient rehabilitation services and home health services had 3Q21 results negatively impacted by COVID cases increasing, which negatively impacted patient volumes. We believe these issues will be temporary. Merit Medical System (MMSI), a provider of consumable medical devices primarily for cardiac procedures, had its share price negatively impacted by rising COVID cases, and the market began pricing in reduced patient procedures in the 4Q21. We believe that procedure volumes will recover going forward.

Portfolio Contributors – Q4 2021

Security	Average Weight (%)	Contribution
Cavco Industries, Inc.	3.06	0.85
Mueller Industries, Inc.	2.34	0.81
Onto Innovation, Inc.	2.17	0.72
Hub Group, Inc. Class A	3.24	0.63
Kirby Corp.	3.11	0.63

Portfolio Detractors – Q4 2021

Security	Average Weight (%)	Contribution
World Fuel Services Corp.	0.92	-0.40
Enccompass Health Corp.	2.16	-0.33
Merit Medical System, Inc.	2.05	-0.30
Columbia Banking System, Inc.	1.65	-0.27
Alight Inc., Class A	2.50	-0.15

Names Added

During the quarter we added two names. With Chesapeake Utilities (CPK), a Delaware based utility company, we are attracted to the company's ability to invest in organic projects to improve shareholder returns. LHC Group (LHCG), a home health provider, was a name that we have owned in the past. We felt that the market was becoming overly pessimistic with the company's valuation as Omicron fears increased. We believe that issues with labor availability will abate and the company will return to growth in 2022 and beyond as the home health industry provides low cost care to patients, while allowing the US healthcare system to deal with the rising aged population.

Names Sold

We exited four names during the quarter. In terms of Axis Capital Holdings (AXS), an insurance and reinsurance company, we have been pleased to see the company and the insurance industry be proactive with rate increases, but are worried that loss cost inflation of legacy liabilities presents a risk, and the insurance industry continues to remain a magnet for capital, which challenges insurance companies to earn appropriate levels of returns.

Columbia Banking System (COLB), a Northwestern US based community bank, announced a merger of equals with Umpqua Holdings (UMPQ). We, as well as the market, were surprised that they would combine. While there may be synergies from the deal over the long term, we have found that mergers of equals are messy from an integration standpoint and the loss of talent from integrations can be disruptive, so we chose to move on.

NorthWestern Corp (NWE), a Northwestern US utility, was a name we had purchased based on the belief that positive change for the company was on the horizon. After a multi-year period of turbulence with regulators, we felt that political changes from a regulatory perspective, and government recognition of the financial impact of volatile out of state purchased power prices could have on the state of Montana, would lead to an improved investment outlook over the holding period. However, COVID disrupted investment activity, and regulators proved to be unaccommodating to Northwestern's desire to generate appropriate returns on investment in the state of Montana. We did not feel there was going to be a reasonable timely solution to the Montana power deficit so we sold the position.

World Fuel Services, a distributor of road, aviation, and marine fuels, was a company that had strong cash flow characteristics, traded around tangible book value, and was exposed to economic normalization. During the quarter, the company announced the acquisition of Flyers Energy Group. The acquisition, while estimated to be accretive, was hard to be pleased about given World Fuel Service's depressed share price. The capital should have been used to more aggressively repurchase outstanding common stock. We felt the capital allocation was not in the best interest of shareholders and sold.

Conclusion

In our last commentary, we spoke about looking forward to 3Q21 earnings releases as we believed that held names would start to differentiate themselves from the index. We have the same feeling heading into the 4Q21 reporting period. An ability to compound 2022 results on top of 2021 results will be a clear differentiating factor in the market going forward. We believe the portfolio is positioned well.

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

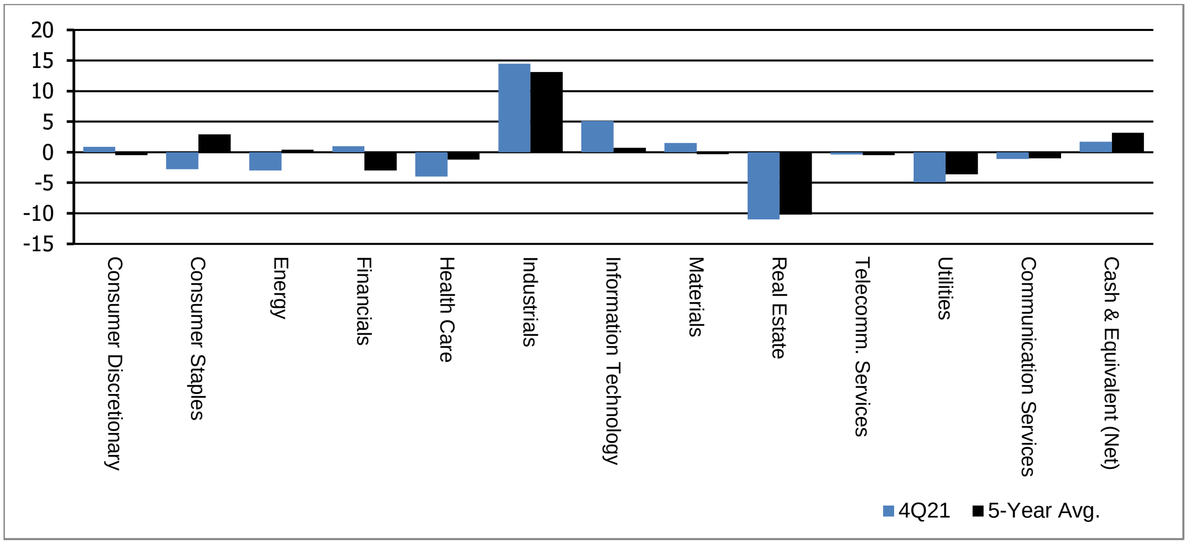


Exhibit 1 above highlights the fact that sector weight differentials between the Fund and the Russell 2000 Value Index benchmark have not changed greatly from today's levels versus the five year average.

Top Ten Holdings (%)

Concentrix Corp.	3.8
Cavco Industries, Inc.	3.6
Kirby Corp.	3.6
Cleveland-Cliffs, Inc.	3.4
Hub Group, Inc. CL A	3.3
Beacon Roofing Supply, Inc.	3.3
Valvoline, Inc.	3.3
Ryder System, Inc.	3.2
Pacwest Bancorp	3.2
Vista Outdoor, Inc.	2.9
Total % of Portfolio	33.6

Fund Characteristics	Fund	Russell 2000 Value Index
Number of Holdings	36	1,451
Return on Equity[1]	4.1	0.1
Weighted Avg Market Cap (Millions)	4,415	2,954
Price/Book[2]	1.9	1.6
P/E using FY1 Estimate[3]	12.2	13.0
Long Term Debt/Total Capitalization[4]	32.1	41.2
Information Ratio (TTM)[5]	0.39	-
Active Share[6]	96.3	-

Source: Factset Research

Portfolio Performance

	Q4 21	1 Year	3 Year	5 Year	10 Year	Since Inception (12/27/10)
Walthausen Focused Small Cap Value Fund: Institutional Class	6.10	28.33	18.20	10.77	12.07	10.57
Russell 2000 Value Index[7]	4.36	28.27	17.99	9.07	12.03	10.22

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 May 31, 2026. The Advisor may not terminate the fee waiver before May 31, 2026. 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] Return on Invested Capital (ROIC) is a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments. The return on invested capital ratio gives a sense of how well a company is using its capital to generate profits.

[11]Same-Store Sales measures the sales of a company's existing stores that have operated for more than one year, excluding sales of new stores.

[12]A special purpose acquisition company (SPAC) is a company with no commercial operations that is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring or merging with an existing 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
(888) 925-8428
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