Teton Advisors

KEELEY Teton Advisors

Small Cap Dividend Value

Third Quarter 2018 Commentary

Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal will fluctuate so that an investor's portfolio, when liquidated, may be worth less than the original cost/balance. As with any investment, there is a potential risk of loss. Smaller and medium-sized company stocks are more volatile and less liquid than larger, more established company securities.

Performance

For the quarter ended September 30, 2018, the Small Cap Dividend Value Strategy fell 1.09% gross (-1.33% net of fees) versus an 1.60% gain for the Russell 2000 Value Index. For the year-to-date period, the Strategy is up 3.59% gross (2.86% net of fees) compared with a 7.14% rise in the benchmark.

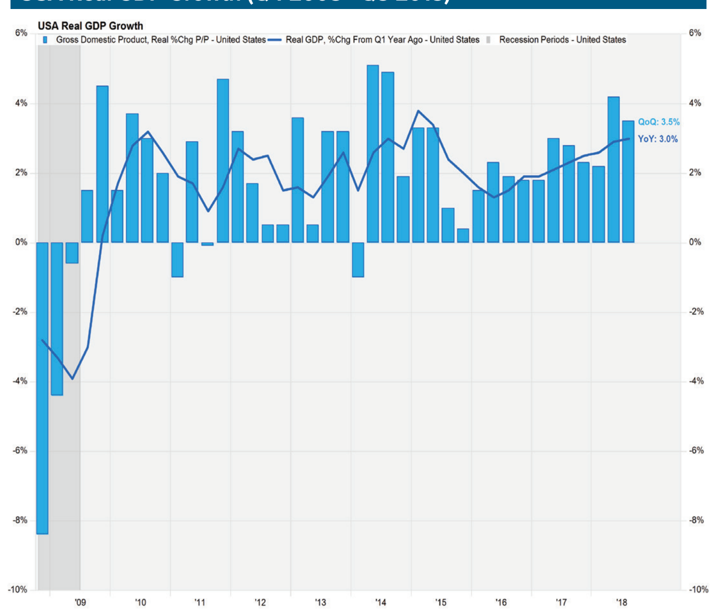
Macroeconomic Review

As we move towards the end of the calendar year, the economy continues to signal domestic strength. Chief among these positive statistics is the unemployment rate, which has declined to 3.7%, the lowest level since the Vietnam War. Yet, despite tight employment conditions where many companies cite talent acquisition as a strategic concern, hourly earnings growth and inflation remain at modest levels, which we believe supports the case that the economy is not overheating. Corporate tax reform has boosted earnings growth and contributed to a general willingness to increase business investment. Likewise, the ISM Non-Manufacturing Index, which also encompasses orders and business activity, marked the highest expansionary reading since mid-2005.

Market Performance

As of September 30, 2018	3 Months	YTD	1-Year
S&P 500 Index	7.7%	10.6%	17.9%
Russell 3000 Value Index	5.4%	4.2%	9.5%
Russell 3000 Index	7.1%	10.6%	17.6%
Russell 2500 Value Index	2.7%	5.7%	10.2%
Russell Midcap Value Index	3.3%	3.1%	8.8%
Russell 2000 Index	3.6%	11.5%	15.2%
Russell 2000 Value Index	1.6%	7.1%	9.3%
Bloomberg Barclays Agg. Bond Index	0.0%	-1.6%	-1.2%

USA Real GDP Growth (Q4 2008 - Q3 2018)



Source: U.S. Bureau of Economic Analysis, Factset. Grey represents recession periods.

Stock indices, however, ended the quarter on the retreat after marking all-time highs earlier this summer. The impact was far more pronounced for small capitalization stocks. Reflecting back to the start of the year, the Trump Administration's opening of a two-front trade war—in China and North America—prompted investors to reallocate towards domestically-focused small caps, which are perceived to be more insulated from such matters. We were supportive of the insulation thesis and felt it provided a reason to remain bullish. Yet in the final days of the quarter, the Trump Administration rather quickly resolved the trade war on one front as NAFTA was restyled the US-Mexico-Canada Agreement (USMCA). Largely perceived by investors and companies as having "dodged a bullet", the new agreement should allow for minimal disruption to existing supply chains and provide reasonable protections, rather than the punitive repudiations implied by earlier rhetoric. With this achievement, and its contemplation as a template for China, small caps lost their perceived advantage over their larger, global brethren. We do remain concerned about the prickly sparring with China, predominantly over trade issues, recognizing both the exposure of technology supply chains and the threat to US consumers through higher price levels. We continue to proactively anticipate potential exposure among our holdings.

The third quarter of 2018 was one of the Strategy's most difficult quarters on a relative basis since its inception nine years ago, as the lower beta, dividend-paying stocks, which are favored by the Strategy, lagged their opposites by significant amounts during this period. According to analysts at Jefferies, non-dividend-paying stocks in the Russell 2000 Value index increased 3.55% while high yielding stocks were up 0.27% and low yielders were up 0.86%. As has been the case for much of the year, larger cap stocks outperformed small caps; the Russell 1000 Index gained 7.4% while the Russell 2000 Index advanced 3.6%. In addition, the Russell 2000 Growth Index continued to outpace the Russell 2000 Value Index, 5.5% vs. 1.6%. These trends continued those we have seen most of this year except for the brief pullback in late January and early February.

While the backdrop of the market challenged the Strategy, we also had some setbacks in particular stocks. One of the ways we discuss performance is to disaggregate it into the impact from sector allocation and stock selection decisions. As we have pointed out in the past, stock selection typically drives most of the Strategy's relative performance. This quarter was no exception as sector allocation was a slight positive, but stock selection had a negative impact. The sector allocation impact primarily came from the new Communications Services sector. This sector used to be within the Consumer Discretionary and Technology sectors and mostly includes Media, Internet, and Telecommunications companies. The Strategy's holdings were centered on Media companies and were overweight against the Russell 2000 Value Index in this new sector, as we have favored these types of names in the Strategy's historical allocation to the previously more broad Consumer Discretionary and Technology sectors.

The Strategy's negative impact from stock selection arose mostly from two sectors Consumer Discretionary and Financials, with smaller negative relative contributions from Industrials and Technology.

The Financials sector is more than twice as large as any other sector within the Russell 2000 Value Index, so small variances in portfolio decision-making can still cause it to be one of the most impactful sectors from a performance perspective. That said, the Strategy held a handful of stocks that were down double-digit percentages during the quarter. While we think the decline in most of these stocks is temporary, the Strategy exited its position in Brightsphere Investment Group after it reported disappointing flow trends in its second quarter results.

The weakness in results within the Consumer Discretionary sector arose mostly from two stocks, Winnebago Industries and Hamilton Beach Brands, which we discuss later in this report.

The Strategy's performance in the Industrials sector was mixed, but on balance unfavorable for the quarter as earnings shortfalls and/or disappointing guidance from Deluxe Corporation, Matthews International, and Astec Industries weighed on the Strategy's results.

The Strategy's biggest contributor and biggest detractor both came from the Technology sector as Hackett rose sharply and Plantronics fell. We discuss both stocks below.

The market has sold off sharply since the end of the quarter and we are writing this update as stocks have traded down for a few days in a row. It is our expectation that the Strategy's strategy of holding dividend-paying small cap stocks is designed to provide better downside protection, and it has done so in most negative quarters since inception. We believe the Strategy will continue to deliver accordingly over the long-term.

Leading Contributors

Hackett Group (HCKT) is a consulting firm that serves large global clients and specializes in benchmarking and implementing best practices. As these technology applications have moved to the cloud, Hackett has retooled its business to serve client initiatives in this area. This transformation created some disruption and caused some disappointment in 2017, but now appears to be gaining traction in revenues and earnings. A solid second quarter provided some evidence of this and drove shares higher.

Berry Petroleum (BRY) is an independent oil exploration and production company. This is the Strategy's second time around with Berry as it held the stock prior to the company's acquisition by Linn Energy in 2013. Linn was a casualty of the decline in oil prices in 2014, and Berry's assets ended up in the hands of Linn's creditors. We participated in the company's recent initial public offering, which marked its return to the public equity markets, because we believed the shares were undervalued. With a new management team, solid hedging program, and low leverage, we believe that Berry is positioned to deliver good results. At the same time, the offering was not well received. We believe that investors did not appreciate the consistency of Berry's business and were overly concerned about the stock overhang from its current shareholders. This may have created an opportunity that contributed early yet remains interesting.

KBR Inc. (KBR) is a leading industrial services company that, through a series of acquisitions, has transformed its business from providing engineering and construction services to global energy producers to having a balanced revenue mix between those services and providing operational support services to US government clients. A combination of factors contributed to gains in the quarter. These included a rebound from weakness earlier in the year, solid second quarter earnings results, and several large new contract wins.

Leading Detractors

Plantronics Inc. (PLT) is the leading maker of headsets for business telephony and computing applications. During the quarter, it completed its acquisition of Polycom, the leading provider of videoconferencing systems. The announcement of the deal drove the stock higher in the first half of the year, but the shares gave back some ground during the third quarter. We believe this was mostly driven by concerns about the leverage Plantronics is taking on in the deal. With the anticipated earnings accretion, we do not think the incremental debt will be a burden.

Hamilton Beach Brands (HBB) designs, manufactures, and sells small kitchen appliances, along with operating a small chain of retail kitchen supplies stores. It appears that the stock came under pressure due to some profit-taking after strength in the second quarter. In addition, reported results were negatively impacted by higher expenses that reduced margins and by the continued under-performance at its kitchen supply retail segment. The "core" Hamilton Beach business was strong and posted nice top-line growth. We believe that the outlook remains favorable and the elevated expenses should start to abate.

Winnebago Industries (WGO) is a leading manufacturer of motorized and towable recreational vehicles (motorhomes, travel trailers, and fifth wheels). The stock has come under pressure on concerns of a peak in the RV cycle and inflationary impacts from steel and aluminum tariffs. In certain parts of the country, dealer inventories looked higher than anticipated due to a late start in the selling season because of a late spring. Winnebago, however, continues to buck the trend by posting solid results as the company gains market share in the towable segment. The overall outlook remains favorable with added excitement from the recent acquisition of iconic boat manufacturer Chris-Craft.

Outlook

As we look to the end of 2018 and beyond, we do not think that the recent weakness is the start of a larger decline. That is not to say that a correction may not occur. We simply do not perceive conditions that would lead to a 40%-50% drop like investors saw in the 2000-2003 and 2008-2009 time periods. Our outlook remains balanced. On the positive side the economy appears to be on solid footing, and this should benefit corporate earnings. On the political side, while there seems to be a lot of noise, the Trump Administration appears to be making some progress on trade and on security. On the negative side, some of that progress seems to come in "a one step back and two steps forward" manner. Other concerns include the remarkably easy credit market conditions, the likely impact of higher rates on US government budget deficits, and what we see as slightly elevated valuations for stocks.

In conclusion, thank you for your investing alongside us in the Small Cap Dividend Value Strategy. We will continue to work hard to justify your confidence and trust.

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Third Quarter Contributors and Detractors

Third Quarter Contributors

Top Contributors	Total Return (%)	Contribution to Return (%)
Hackett Group, Inc.	25.39	0.37
Berry Petroleum Corporation	30.37	0.30
KBR, Inc.	18.39	0.30
John Bean Technologies Corporation	34.32	0.23
Bank of N.T. Butterfield & Son Limited (The)	14.29	0.20

Third Quarter Detractors

Largest Detractors	Total Return (%)	Contribution to Return (%)
Plantronics, Inc.	-20.74	-0.39
Hamilton Beach Brands Holding Co. Class A	-24.20	-0.35
Winnebago Industries, Inc.	-18.13	-0.34
Diebold Nixdorf Incorporated	-48.02	-0.31
Virtu Financial, Inc. Class A	-22.23	-0.27

Source: Factset

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Past performance is no guarantee of future results. As with all investments, there is a risk of loss. Any performance and/or attribution information contained herein are based on a representative account of the specific strategy discussed.

Market Performance presented solely for informational purposes. The S&P 500 Index is designed to act as a barometer for the overall U.S. stock market and consists of 500 stocks that are chosen on the basis of market size, liquidity, and industry grouping. The S&P 500 is a market value weighted index with each stock's weight in the index proportionate to its market value.

The Russell 2000® Value Index is an unmanaged index that measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000® Index is an unmanaged index that measures the performance of the smallest 2,000 companies by market capitalization of the Russell 3000® Index.

The S&P SmallCap 600® measures the small-cap segment of the U.S. equity market and is unmanaged. The index is designed to track companies that meet specific inclusion criteria to confirm that they are liquid and financially viable.

The S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, measures the performance of mid-sized companies reflecting the distinctive risk and return characteristics of this market segment.

The Russell 2500® Value Index is an unmanaged index that measures the performance of the small to mid-cap value segment of the U.S. equity universe and includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2500® Index is an unmanaged index that measures the performance of the 2500 smallest companies by market capitalization of the Russell 3000® Index.

The Russell Midcap® Value Index is an unmanaged index that measures the performance of the mid-cap value segment of the U.S. equity universe and includes those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values.

The Russell Midcap® Index is an unmanaged index that measures the performance of the 800 smallest companies by market capitalization of the Russell 1000® Index.

The Russell 1000® Index is an unmanaged index that measures the performance of the 1,000 largest companies by market capitalization of the Russell 3000® Index.

The Russell 3000® Value Index is an unmanaged index that measures the performance of the broad value segment of the U.S. equity universe and includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 3000® Index is an unmanaged index that measures the performance of the 3,000 largest U.S. companies by market capitalization.

The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS.

A direct investment into any of these indices is not possible.

The opinions expressed in this document are those of Keeley Teton Advisors, LLC as of the date indicated and are subject to change without notice and are not intended as recommendations of individual securities.

The net performance numbers shown are for informational purposes only. Management fees are negotiable and a table of standard fees is contained in the Firm's Form ADV Part 2A, which is available at no cost at www.keeleyteton.com.

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