TRIBUTARY
CAPITAL MANAGEMENT

SMALL CAP EQUITY MARKET COMMENTARY

PORTFOLIO MANAGERS: MARK WYNEGAR & MIKE JOHNSON

THIRD QUARTER 2018

	Quarter	Year to Date	1 Year	3 Years	5 Years	10 Years
Tributary Capital Management (Gross of Fees)	4.9%	10.6%	13.0%	17.1%	12.8%	12.8%
Tributary Capital Management (Net of Fees)	4.7%	9.9%	12.0%	16.1%	11.9%	11.8%
Russell 2000 Index	3.6%	11.5%	15.2%	17.1%	11.1%	11.1%
Russell 2000 Value Index	1.6%	7.1%	9.3%	16.1%	9.9%	9.5%

MARKET REVIEW

The Tributary Small Cap Equity Strategy returned +4.9% in the third quarter of 2018, beating the Russell 2000 benchmark's return of +3.6%. Growth beat value this quarter with the Russell 2000 Growth Index returning +5.5% versus a return of +1.6% for the Russell 2000 Value Index.[1]

In general, companies with higher valuations, higher market capitalizations and lower dividend yields tended to outperform. The three best performing sectors in the small cap market were Communication Services (+13%), Healthcare (+8%) and Information Technology (+6%). The three worst performing sectors in the small cap market were Energy (-3%), Consumer Staples (-2%) and Real Estate (flat).[1]

The portfolio's two best performing economic sectors vs. the Russell 2000 were Consumer Discretionary and Materials. In the Consumer Discretionary sector, the portfolio returned +19% vs. +4% for the Russell 2000 Consumer Discretionary sector. In Materials, the portfolio's sector return of +10% compared favorably to the Russell 2000 Materials sector return of +1%.[1]

The portfolio's two worst performing economic sectors vs. the Russell 2000 this quarter were Information Technology and Real Estate. In Information Technology, the portfolio's +2% sector return compared unfavorably to the Russell 2000 Information Technology sector's return of +6%. Technology holdings in the Russell 2000 Growth benchmark were +8% versus +1% for Russell 2000 Value technology holdings. No exposure to a strong performing software industry (+12%) contributed to the portfolio's relative underperformance. This difference partially explains some of the portfolio's underperformance in this sector. In the Real Estate sector, the portfolio's -3% return compared unfavorably to the Russell 2000 Real Estate sector's flat return in the quarter.[1]

PORTFOLIO CHANGES

In the third quarter, one company was added to the portfolio. *Big Lots* is a value retailer of discounted products in furniture, food, consumables, soft good home products, seasonal products, hard goods, electronics and toys.

There was one elimination from the portfolio during the third quarter. *A Schulman* was sold due the announced acquisition of the company by LyondellBasell.

One company was acquired during the quarter. *Education Realty Trust* was acquired by *Greystar Real Estate Partners* for $41.50 per share in cash.

TOP CONTRIBUTORS

Omnicell, a manufacturer of medication and supply dispensing systems to the healthcare industry, has continued to see positive sales momentum for their new automation system called the XT.

Forward Air, a transportation and logistics company, is benefiting from tight industry conditions that continue to drive revenue growth.

Five Below, a retailer of low-priced, trendy merchandise to the teen and pre-teen customer, reported quarterly results that included strong same-store sales and continued growth in its store base.

Selective Insurance Group, a property and casualty insurance provider, reported robust results in its Commercial & Personal lines of business, offsetting disappointing Excess & Surplus results.

LHC Group, a home health services company, reported solid organic revenue growth in its Home Health business and the integration of the Almost Family acquisition appears to be on track.

TOP DETRACTORS

Granite Construction, a diversified heavy civil contractor and construction materials producer, reported relatively weak Construction segment results on a slower seasonal start and the Large Project Construction segment completed a significant amount of lower margin work in the most recent quarter.

PDC Energy, an energy exploration and production company, raised their capex guidance in the most recent quarter. In addition, there is a ballot initiative in Colorado that could negatively impact drilling opportunities in that state if approved by voters.

American Woodmark, a manufacturer of kitchen cabinets and vanities, reported a largely solid quarter and guided organic growth guidance slightly higher. Unfortunately, building product stocks appear to be out of favor over concerns that rising interest rates will weaken housing activity.

Varex Imaging, a manufacturer of x-ray tubes and digital image detectors, reported a poor quarter due to a delay in CT tube shipments to China, reductions in inventory levels as certain customers evaluate relocating their manufacturing and seasonal weakness in Japan.

Marcus & Millichap, a commercial real estate broker, guided for the second half of 2018 to be more challenging as it faces tougher comparisons from a year ago. In addition, the company described the commercial real estate market as healthy, but not accelerating.

PORTFOLIO OUTLOOK

Equity markets and economic measures continued to improve in the third quarter. The Dow Jones Industrial Average, S&P 500, NASDAQ Composite, and the Russell 2000 hit new all-time highs during the quarter. The continued rise in the equity markets has been supported by a number of strong economic measures: 4.2% real gross domestic product (GDP) annualized growth rate for the second quarter, August unemployment rate of 3.9% at its lowest level since 2000, new claims for jobless benefits at a 50 year low, and household net worth rising to a record high.

The U.S. economy has been supported by accommodative interest rates, a stimulative fiscal policy, and reduced regulatory constraints. These factors provided a solid foundation for the strong August consumer confidence and manufacturing sentiment surveys. However, there is concern that global economic activity may be disrupted due in part to volatility caused by trade negotiations. A number of our trading partners, including Mexico, Canada, the European Union and China, have all been impacted by tariffs imposed by the United States. China, in particular, has been singled out by President Trump as having significantly unfair trading practices and lax intellectual property protections. In response, the President has levied tariffs on $250 billion in goods coming from China. In response, China has announced the intent to exact tariffs of its own on U.S. exports. In total, imports and exports under newly imposed tariffs account for more than 2% of U.S. GDP. The small immediate impact on the economy may explain the market's largely subdued response to escalations in ongoing trade negotiations. However, if current and threatened tariffs carry into 2019, GDP growth could be cut by as much as a full percentage point according to Oxford Economics[2]. This would be a considerable headwind to an economy expected to grow at a 2.4% - 2.8% rate[3]. As it applies to investing, companies in the Russell 2000, are more insulated from the direct impact of tariffs, as they generate approximately 20% of their revenues from overseas, compared to 35% for companies in the S&P 500 according to estimates from Factset. The lower international exposure also serves as a buffer against the strength of the U.S. dollar. However, smaller companies may have fewer options to adjust their supply chains, increase operational efficiencies, or absorb price increases.

The Russell 2000 has delivered a total return of 11.5% year to date, though participation has not been broad based. Only four economic sectors are outperforming the index, Healthcare, Information Technology, Communication Services and Consumer Discretionary, while lagging sectors trailed the index by an average of 740 basis points. Investors' appetite for risk is evident in the performance of the Russell 2000 Growth Index, up 15.8%, which has more than doubled its Value counterpart, up 7.1%. Year-to-date, stocks with the most expensive price-to-earnings ratios have outperformed their more cheaply valued peers, and companies projected to have negative earnings over the next twelve months have outperformed companies projected to have earnings by more than half. These measures indicate that investors have been more attracted to companies viewed as having outsized future earnings growth opportunities than those currently generating profits.

Looking ahead, current earnings growth estimates for 2018 are between 24% - 29% for the Russell 2000 Index. These estimates are higher than where they began the year. Valuations are above – and in some cases well above – their long-term averages on a number of valuation measures. However, smaller companies appear to be more attractively priced than their S&P 500 counterparts. This may be due to the higher growth rates expected for small capitalization companies in 2019 of 11% - 19% compared to 9% - 13% for the S&P 500 Index.

Our approach to investing will always focus on owning a fully invested, diversified portfolio of quality businesses at attractive prices. We believe the companies in our portfolio will continue to grow their intrinsic value for our shareholders and represent value that will be rewarded by the market over time.

[1] *Factset Research Systems*

[2] *Oxford Economics, Wall Street Journal September 19, 2018*

[3] *Federal Open Market Committee, Congressional Budget Office, Organization for Economic Cooperation and Development*

The performance numbers shown above are for the Tributary Small Cap Equity Composite and are expressed in U.S. dollars. The composite includes all discretionary accounts with an initial market value of $750,000 that are generally invested in a small capitalization equity strategy. The inception date of the Small Cap Equity Composite is June 30, 1996. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Value Index measures the performance of the small-cap value segment by including those companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index is composed of small-capitalization U.S. equities that exhibit growth characteristics. Performance results are total return and include the re-investment of dividends and capital gains. It is not possible to invest directly in the Russell 2000 Index, the Russell 2000 Value Index, or the Russell 2000 Growth Index.

Net-of-fees composite returns were calculated using the actual aggregate investment advisory fees applicable to portfolios within the composite. Net performance is reported net of investment advisory fees and transaction costs. Capital gains and dividends are reinvested for performance calculations.

Stocks of small companies are subject to market risk and may be more volatile and less liquid than stocks of large companies. Comments are provided as general market commentary and should not be considered investment advice or predictive of any future market performance. Sector performance in commentary is stated gross of fees.

It should not be assumed that an investment in securities identified was or will be profitable or that the investment decisions we make in the future will be profitable or will equal the performance of the securities discussed herein. Holdings are subject to change. The holdings identified do not represent all of the securities purchased, sold or recommended for the portfolio. The holdings listed should not be considered recommendations to purchase or sell a particular security. The "Top Contributors" and "Top Detractors" represented are based on contribution to portfolio return. To obtain the contribution calculation methodology and a complete list of every holding's contribution to the overall portfolio's performance during the quarter, please contact clientservices@tributarycapital.com.

Tributary, an SEC Registered Investment Adviser, is the combined entity of the prior Tributary (formed Jan. 1, 2005) and First Investment Group (formerly a department of First National Bank of Omaha) which merged in May 2010. This event constituted a change in ownership only, as the investment strategies and personnel remained the same for each of the prior firms. Tributary is a wholly owned subsidiary of First National Bank, a wholly owned subsidiary of First National of Nebraska, Inc. and manages mutual funds and equity and balanced portfolios. Tributary Capital Management, LLC ("Tributary") claims compliance with the Global Investment Performance Standards (GIPS®). A fully compliant presentation can be requested by emailing clientservices@tributarycapital.com.

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