TRIBUTARY
CAPITAL MANAGEMENT

SMALL CAP EQUITY MARKET COMMENTARY

PORTFOLIO MANAGERS: MARK WYNEGAR & MIKE JOHNSON

FIRST QUARTER 2019

	Quarter	Year to Date	1 Year	3 Years	5 Years	10 Years
Tributary Capital Management (Gross of Fees)	13.0%	13.0%	2.7%	11.0%	8.3%	16.9%
Tributary Capital Management (Net of Fees)	12.8%	12.8%	1.8%	10.0%	7.4%	15.9%
Russell 2000 Index	14.6%	14.6%	2.1%	12.9%	7.1%	15.4%
Russell 2000 Value Index	11.9%	11.9%	0.2%	10.9%	5.6%	14.1%

MARKET REVIEW

The Tributary Small Cap Equity Strategy returned 13.0% in the first quarter of 2019, trailing the Russell 2000 benchmark's return of 14.6%.[1]

The Russell 2000 Growth Index outperformed the Russell 2000 Value Index by 530 basis points, returning 17.2% and 11.9%, respectively. Companies with higher valuations, higher betas, negative ROEs/ROAs and no/low dividend yields tended to outperform. According to FactSet Research, small cap stocks in the Russell 2000 with negative projected earnings in the next 12 months were up approximately 23% while stocks with positive projected earnings were up only 13%. The best performing sectors in the small cap market were information technology (+23%), energy (+20%) and real estate (+18%). The worst performing sectors in the small cap market were consumer staples (+7%), financials (+9%) and utilities (+10%).[1]

The portfolio's two best performing economic sectors relative to the Russell 2000 were financials and materials. In financials, the portfolio's +11% return bested the +9% return for the Russell 2000 financial sector. The portfolio's bank holdings were a positive, returning +10% vs. +7% for the banks in the Russell 2000. In materials, the portfolio's sector return of +23% compared favorably to the Russell 2000's materials sector return of +17%. All three holdings within the portfolio outperformed the benchmark sector return.[1]

The portfolio's two worst performing sectors vs. the Russell 2000 were healthcare and information technology. In healthcare, the portfolio's +13% sector return compared unfavorably to the Russell 2000 healthcare sector's return of +17%. Higher growth healthcare stocks performed better than value-oriented companies. Biotech stocks were up 24% in the first three months of 2019 after being down 17% in calendar year 2018. Historically, our portfolio has been underweight the biotech industry as those companies do not typically exhibit characteristics that fit our definition of a quality company. Also contributing to relative underperformance was AMN Healthcare. Earnings results released in February 2019 fell short of expectations due to IT system issues within their physician placement business and near term weakness from a large customer in the temporary nurse business. In the information technology sector, the portfolio's +18% sector return was below the Russell 2000 information technology sector's return of +23%. The Russell 2000 Value technology sector returned +19% vs. +24% for the Russell 2000 Growth technology sector. The software industry was up 30% and our portfolio has no exposure. This industry tends to be populated with more growth-oriented companies, expensive valuations, and a significant number of them have negative projected earnings in the next year. Our investment philosophy tends to steer us away from companies with these attributes. Additionally, some technology holdings in the portfolio could not keep up with the average return for the Russell 2000 information technology sector this quarter.[1]

PORTFOLIO CHANGES

There were no additions to the portfolio in the first quarter.

There was one elimination during the quarter. *MultiColor Corporation* was eliminated from the portfolio after it received an all cash bid to be acquired by Platinum Equity Partners.

TOP CONTRIBUTORS

Nexstar, a television broadcaster, reported strong revenue growth driven by record mid-term election political advertising spending and continued strong growth in recurring retransmission fee revenue from pay TV providers. Margins were also up strongly on a leveraging of fixed costs.

American Woodmark, a manufacturer of kitchen cabinets and vanities, recovered along with other housing-related stocks after being pushed down during 2018 on housing/recession concerns. Housing trends did slow in second half of 2018, but appear to be picking up early this year.

Omnicell, a manufacturer of medication and supply dispensing systems to the healthcare industry, reported quarterly results and guidance above expectations. Management suggested the XT upgrade cycle is only in the second inning and the margin target of 15% has upside if momentum continues.

MTS Systems, a provider of testing systems and sensors used in the R&D process of its customers, recovered nicely during the market rally after underperforming slightly in 2018. The company is sitting on a record total backlog, the sensors business is seeing record order levels and the company has said it sees minimal impact of any tariffs that may be put in place.

CACI International, an information technology and network services provider, reported +2% organic growth and strong cost management allowing them to exceed EPS expectations. They also announced two acquisitions that are expected to possess faster than corporate average growth and higher than corporate average margins.

TOP DETRACTORS

AMN Healthcare, a healthcare workforce solutions provider, reported disappointing fourth quarter sales, paired with materially weak first quarter of 2019 sales guidance. Their physician placement business continued to be plagued by IT system problems and a large customer is temporarily dialing-back its first quarter utilization levels for temporary nursing positions.

Navigant Consulting, a business consulting firm, downwardly revised its profit outlook for 2019 due to weakness in its financial services customers and increased future operating expenditures on investments in tools, technology and people.

MSG Networks, an owner/operator of regional sports and entertainment networks, received a downgrade in early January from an analyst based on his projection for slower growth in 2019. In February, the company reported a quarter that beat revenue and operating income expectations.

Columbia Banking, a bank holding company with locations in Washington, Oregon and Idaho, reported a weak quarter as both loans and deposits declined, fee income was lower and operating expenses were higher.

Emergent BioSolutions, a developer of medical countermeasures for biological/chemical threats, infectious diseases and opioid overdoses, was negatively impacted by the FDA releasing a statement discussing its efforts to increase access to Naloxone, a drug used to effectively treat opioid overdoses. While this move by the FDA may provide more growth opportunities for Emergent, there is concern that pricing may come down and it could draw more competitors into the market.

Portfolio Outlook

Following the late 2018 selloff, the market bounced back sharply in the first quarter. Investors' preference for risk and growth is very similar to what was driving the market for the majority of 2018. This reversal from the heightened risk aversion in the closing months of 2018 has been supported by accommodative Federal Reserve actions and policy statements. In early January, messaging from the Fed emphasized that it would be "data dependent". The dot plot issued in March indicated that they did not expect any changes to their current target federal funds rate of 2.25% to 2.5% during 2019. Additionally, they expect to complete their balance sheet runoff in September of this year, ending their quantitative tightening cycle.

Quantitative easing since the Great Recession has been pushing yields lower and possibly decreasing investors' perception of risk. This can be seen in the falling term premium, the additional yield investors demand for the risk of lending over long periods. Historically, inflation concerns have kept term premiums positive. However, the term premium on a 10-year zero coupon bond has been negative for most of the period from July of 2011 to present. This has likely contributed to the recent inversion of the 10-year and 3-month Treasury yield curves as well as the 10-year and 1-year Treasury yield curves. Yield curve inversions have historically been fairly accurate predictors of recessions, though a recession may not occur for 6 to 24 months. Forecasting the timing and/or the magnitude of a recession is not something we can accurately predict. However, we do pay attention to, and want to be aware of, historical economic and market relationships.

The final fourth quarter GDP measurement was 3% on an annualized basis. At the time of this writing, the Atlanta Federal Reserve's GDPNow model's estimate is for 2.1% real GDP growth in 2019. Corporate profit estimates for small cap companies range from 2.8% to 7.3% in 2019, down considerably from 2018's estimated 30% growth rate. Of course, 2018 experienced a sugar high from the 2017 Tax Cuts and Jobs Act. Regardless, even 7.3% growth is still half of the 2014 to 2017 average of 14% earnings growth.

The economy is slowing but is underpinned by a number of positive fundamental factors. Employment remains strong across all age groups. Recently, real wages have begun increasing and outpacing inflation. Nearly 70% of the U.S. economy is driven by personal consumption and a strong consumer can continue to drive growth. Additionally, mortgage rates are currently hovering near 4%, which should support the housing market that has yet to fully recover.

The most notable clouds on the horizon are the potential knock on effects from a slowdown in international growth and possible disruptions to international trade. The Organization for Economic Cooperation and Development estimate for 2019 global growth is 3.3%, down 20 basis points from November. Growth projections have been reduced in almost all G20 economies.

Commentary surrounding U.S. and China trade relations has been mostly positive at the start of 2019. The indefinitely delayed tariff increase on $200 billion of Chinese imports, from 10% to 25% has supported the market's rebound. However, negotiations appear to be fluid, with no certainty on when a deal may be reached. Additionally, there is the possibility that the U.S. places new tariffs on European auto imports. In mid-February the Commerce Department concluded its assessment of whether imported cars and parts pose a national-security threat. The results were not made public, but the administration has 90 days from delivery of the report to announce new tariffs or other barriers. Any developments that appear to limit trade between the Eurozone and the U.S. might spook the market.

Small companies are relatively attractive on valuation. Currently, the S&P 600's forward P/E ratio is 16.7x, fairly valued relative to its long-term average of 16.5x and looks similarly valued on the P/S and P/B value measures as well. However, the S&P 600 is trading slightly below its long-term average to the S&P 500 on a P/E basis and at a significant discount on the P/S and P/B measures.

[1] *Factset Research Systems*