TRIBUTARY CAPITAL MANAGEMENT

SMALL/MID CAP EQUITY MARKET COMMENTARY

PORTFOLIO MANAGERS: DON RADTKE & MARK WYNEGAR

THIRD QUARTER 2018

	Quarter	Year to Date	1 Year	3 Years	Since Inception*
Tributary Capital Management (Gross of Fees)	6.7%	10.7%	16.4%	N/A	16.1%
Tributary Capital Management (Net of Fees)	6.5%	10.1%	15.6%	N/A	15.5%
Russell 2500 Index	4.7%	10.4%	16.2%	N/A	15.7%
Russell 2500 Value Index	2.7%	5.8%	10.2%	N/A	9.2%

**Inception: 12/31/2016*

PORTFOLIO REVIEW

The Russell 2500 benchmark increased +4.7% in the third quarter of 2018. Value underperformed growth in the quarter, with the Russell 2500 Value Index +2.7% versus an increase of +7.2% for the Russell 2500 Growth Index. This difference was most pronounced in the Information Technology sector, where "growth" tech was up +13% compared to +5% for "value" tech.[1]

On a valuation basis, higher returns and higher valuation were directly correlated this quarter. The Russell 2500's highest PE quintile (PE's greater than 30x) was up +9%, while the lowest PE quintile (PE's less than 12x) was up only 1%. Stocks with negative earnings were up 5%. From a dividend perspective, the lowest yielding quintile of stocks posted the strongest performance, up +7%. The highest yielding quintile was up +2%.[1]

The top performing sectors in the Russell 2500 this quarter were Information Technology (+10%), Healthcare (+10%) and Industrials (+7%). The weakest sectors included Consumer Staples (-1%), Real Estate (flat) and Energy (flat).[1]

The performance of the Small/Mid Portfolio exceeded the benchmark this quarter, providing a total return of +6.7%. The portfolio's strongest relative performance was in the Consumer Discretionary and Healthcare sectors. In Consumer Discretionary, the portfolio had a +10% return versus a +2% return for the Russell 2500 Consumer Discretionary sector. In Healthcare, the portfolio's sector return of +15% exceeded the Russell 2500 Healthcare return of +10%. PerkinElmer, Omnicell and ICON were key contributors among the portfolio's Healthcare holdings, but were offset somewhat by weaker performance from AMN Healthcare.[1]

The portfolio's weakest area versus the Russell 2500 was Information Technology, where the portfolio's holdings were +9%, versus +10% for the Russell 2500 sector. Littelfuse detracted from performance in this sector, but was offset by favorable performance from Broadridge Financial. In addition, much of this quarter's disparity between the growth and value components of the market was derived from the Technology sector.[1]

On a year-to-date basis, the Small/Mid Portfolio is slightly ahead of the Russell 2500 benchmark, with a total return of +10.7% versus +10.4% for the index. The growth versus value disparity remains a driving force for the market, with the Russell 2500 Growth +15.8% year-to-date and the Russell 2500 Value +5.8%. Favorable performance in the portfolio's Materials, Consumer Discretionary, Healthcare and Real Estate holdings this year have been offset by underperformance in the Information Technology, Financials and Industrials sectors.[1]

PORTFOLIO CHANGES

During the quarter, one new position was added to the portfolio and two were removed.

Big Lots was added to the portfolio in September. This company is a value retailer of discounted products in furniture, food, consumables, soft home goods, seasonal products, hard goods, electronics and toys. Big Lots has recently initiated a plan to refurbish its stores, and is experiencing improved sales and margins at remodeled units. With updates completed at fewer than 200 of its 1,400 stores, we believe this can be a driver for the company for some time.

Five Below, a retailer of low-priced, trendy merchandise to the teen and pre-teen customer, was sold in August following a period of strong performance. *Education Realty Trust*, a REIT focused on student housing, was acquired by Greystar Real Estate Partners for $41.50 per share in cash in September.

TOP CONTRIBUTORS

PerkinElmer, a provider of diagnostic solutions for the healthcare industry as well as products to assist in life science research, reported favorable organic growth due to strong end markets and new product offerings, as well as solid margin expansion.

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.

Broadridge Financial Solutions, a provider of investor communication services for banks, corporate issuers and mutual funds, provided better than expected guidance for fiscal 2019.

ICON, Plc, a contract research organization that provides services to the pharmaceutical, biotechnology and medical device industries, reported strong bookings within its large pharma client base.

Total System Services, a provider of electronic payment processing services to banks and other financial institutions, reported better than expected earnings driven by strong top line growth.

TOP DETRACTORS

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.

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

Littelfuse, a manufacturer of circuit protection products and sensors for the electronics and automotive industries, posted a solid earnings report, but guided estimates down for the upcoming quarter.

AMN Healthcare Services, a provider of temporary staffing services for the healthcare industry, reported weaker than expected demand in its Travel Nurse business.

Affiliated Managers Group, an asset management company with strategies in U.S. and global equities, as well as the alternatives space, reported inflows from institutional investors, but modest redemptions in mutual funds and from high net worth investors.

Portfolio Outlook

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. China reacted by announcing its 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, smaller cap companies are more insulated from the direct impact of tariffs. As measured by the Russell 2000, small cap companies generate approximately 20% of their revenues overseas, compared to 25% for companies in the Russell Midcap Index and 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 2500 has delivered a total return of 10.4% year-to-date. Investors' appetite for risk is evident in the performance of the Russell 2500 Growth index, up 15.8%, which has more than doubled its value counterpart, up 5.7%. 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 nearly two times. 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 small cap stocks and 21% - 24% for mid cap stocks. 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 valuation measures. However, small and mid cap companies appear to be more attractively priced than their S&P 500 counterparts. This may be due to the higher earnings growth rates expected for small cap (+11% - 19%) and mid cap companies (+13 – 15%) in 2019 compared to 9% - 13% for the S&P 500.

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/Mid Cap Equity Composite and are expressed in U.S. dollars. The composite includes all discretionary accounts with an initial market value of $500,000 that are generally invested in the Small/Mid Cap Equity Strategy. The inception date of the Small/Mid Cap Equity Composite is December 31, 2016. The Russell 2500 is a market cap weighted index that includes the smallest 2,500 companies covered in the Russell 3000 Index. It consists of a blend of small and mid cap stocks "smid", and can describe any company up to the $10 billion market cap range. The Russell 2500 Value Index is a subset of the securities found in the Russell 2500 Index which includes companies that exhibit a value probability. The Russell 2500 Growth Index is designed to measure the performance of those Russell 2500 companies with higher price-to-book ratios and higher forecasted growth values.

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.

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.

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.

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