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ValueLine*funds*

Boring Is Beautiful

High-quality small-cap companies with a track record of steady earnings growth may not appear cheap on standard measurements. But when viewed from the perspective of earnings capacity and durability, many of these consistent earners offer compelling investment opportunities. Stephen Grant, portfolio manager of the Value Line Small Cap Opportunities Fund, takes a long-term perspective on valuation in search of quality and growth in the small-cap space.

Stephen E. Grant
Portfolio Manager

Stephen Grant has been a portfolio manager with the Value Line Funds since 1991. Over the past 20 years, Mr. Grant's quantitative/behavioral methodology has been used by several equity and hybrid funds. This disciplined investment strategy concentrates on high-quality companies that have superior and consistent long-term records of growth in both earnings and stock prices.

Mr. Grant has a B.A. in Economics from Stanford University and an MBA in Finance from the Wharton School of the University of Pennsylvania.

What is the history of the fund?

Value Line started providing research in 1931 and opened its first mutual fund in 1950. The Small Cap Opportunities Fund was launched in 1993, and I have been the manager since 1998. It currently has approximately $500 million in assets.

We place great emphasis on risk control, especially in the volatile small-cap arena and we also are different from our peers in our low turnover and, as a result, our low trading cost.

How do you define small cap?

For us it is merely a definition of small cap used by a well-known investment research firm, which can vary from month to month. Right now the average cutoff on small cap is about $4 billion, so almost all the investments we make are below $4 billion at the time we invest.

Liquidity is certainly a challenge in the small-cap market, especially when we are talking about a fairly large mutual fund. So generally we don't buy stocks with a market cap lower than $1 billion, unless perhaps they trade at a higher volume than a typical small-cap company. Typically the range we are looking at is between $1 billion and $4 billion at the time of purchase.

We don't view small cap as being that different a playing field than mid cap, for example; they both allow us to implement our strategy of finding high-quality companies we like and holding them for a long time. It is somewhat challenging because we typically like to see at least 10 years of consistent growth in earnings and stock price, but many small-cap companies have a shorter track record. So when a stock that otherwise meets our standards has a shorter track record, we take a smaller relative weighting.

What are the underlying principles of your investment philosophy?

Controlling risk is very, very important for us. Our philosophy is that if you avoid the big losses, the gains take care of themselves. Also, it's very important to us to minimize trading costs.

We believe we can achieve above-average returns, and at the same time hold down our exposure to risk, by seeking consistent companies we can hold in the portfolio for many, many years. Our real strength shines through in weak market periods, when our peers lose more money than we do. In strong bull markets we may well lag our peers because of our higher quality holdings—but in flat or weak markets our strategy really pays off.

What is your investment strategy?

We invest in high-quality companies with a history of solid, consistent growth. A company need not have the fastest growth rate around, but it must have a sound track record of consistent performance.

"To get the best odds for selecting the winners of the future, we believe we should invest in companies that already have shown they have what it takes to succeed."

We seek companies that already are proven winners that have grown their earnings and their stock price consistently for many years, preferably 10 years or more. To get the best odds for selecting the winners of the future, we believe we should invest in companies that already have shown they have what it takes to succeed.

We invest in high-quality companies with strong, stable, proprietary products and services, and often strong brand names as well. This gives them a powerful footing in their market niche and a clear competitive advantage. In other words, they are protected by a wide moat with high barriers to entry, and are less exposed to swings in economic conditions. As a result, these companies have good control over their own destinies, plus superior profit margins and returns on capital. Also, they have more stability, and can ride the ups and downs more smoothly. These high-quality companies also have a favorable corporate culture of maximizing shareholder value and strong management teams that know how to fully leverage their competitive advantages.

Let me tell what you will not find in our portfolios. You won't find companies with undifferentiated commodity products or "me-too" service offerings or heavy exposure to economic cycles; no commodity, chemical or metals companies; no homebuilders; no airlines; no deep cyclicals. There are some technology and biotech companies, but only those that have established a consistent track record.

We find companies that meet our requirements through a combination of quantitative screens and fundamental research. Our exact screen methods are proprietary; suffice it to say we are disciplined in determining which stocks meet these requirements and enter the portfolio.

We certainly don't set any price targets or have any cut-offs of either the gains or losses of a holding. We simply continually evaluate all the holdings in the portfolio and judge them as they look that day. But because we buy high-quality companies with consistent track records, we do have patience if one suffers one or two bad quarters; we know they are more than likely to bounce back nicely from any short-term problems.

Would you walk us through your research process?

In the search for new names we always look at quarterly earnings report and news and stock charts every day to see if there are any winning stocks that we don't already own. We examine those names to see whether they meet strict criteria that I have outlined.

Let me give you a couple of examples of the fund's holdings. In the healthcare sector we own very little in biotech, an industry that is notorious for volatility and high risk. Instead we own Healthcare Services Group, Inc., whose market cap is about $3 billion. It's a provider of laundry and food service to thousands of healthcare facilities around the country, and has a long history of consistent growth. Many would call it a boring business—but to us boring is beautiful, we love boring.

There are examples like that throughout the portfolio. Another is in the industrials sector, where the fund is overweighted. We own the kinds of industrial names that operate in markets that are less sensitive to business conditions, such as waste disposal, pest control, and maintenance. One stock that was attractive to us was CLARCOR Inc., which provides filters and filtration products and services in many diverse markets, such as waste water, healthcare, and residential. That stock provided many years of solid consistent growth before it was just recently acquired.

The Value Line ranking system is one tool we use. We usually buy stocks that are in the top three ranks of the ranking system. Sometimes the system will call a stock to my attention that's doing well, that perhaps I've overlooked and ought to take a closer look at. We do have wide latitude.

What drives your sell discipline?

The sell discipline is a very important way we hold down risk. Really it's very basic: any stock that we would no longer buy doesn't belong in the portfolio and must be sold. It's important to never fall in love with any holding. We do have some patience for one or two bad quarters, but if the stock has been going sideways or down for some period of time, then it really no longer meets our requirements and we would sell it.

Would you also sell a stock if it graduates to mid-cap market capitalization?

That's something we keep an eye on. We want to stay a small-cap fund, and the fund always has names that are moving up into the mid-cap space. So we trim back some stocks just to make sure the average market cap in the portfolio meets the requirements for a small-cap fund.

How is your portfolio constructed? Is your fund diversified?

It is very much a bottom-up approach, stock by stock. We do not make any calls on the economic outlook or on particular sectors. We don't try to time the stock market. We just want to invest in the best companies, in stocks we can hold for many years no matter what the outlook is for a particular sector or business conditions.

Currently, the fund holds 125 to 150 stocks—but many are very small holdings in companies that meet our criteria but whose track records are too short. Some will become important contributors to the portfolio while others will never leave the minor leagues and will be cut from the fund.

The fund is well diversified. Certainly our style is growth, and we have only a few holdings in the energy sector or basic materials or real estate. As far as size, only a few holdings are as much as 2% of assets. Most of these names have limited liquidity, too, and we like to stay well diversified—so once a holding starts getting past 2% we get less comfortable.

The fund's turnover is generally in the 10% to 20% range. The category average is more like 70%, 75% annual turnover, so we have the advantage of lower trading costs. We can do that because we invest in high-quality, consistent firms that usually merit staying in the portfolio for a long time.

We know from the great track record of these companies that we should have some patience and give them the chance to come through and shine, as they always have in the past, even if they hit some occasional bad periods.

We use the Russell 2000 Index as our benchmark.

What growth characteristics do you focus on?

Value is a secondary consideration, certainly not a prime consideration. The most important aspect is consistent growth or a demonstrated track record. We don't mind paying up for a stock. In fact, a lot of these stocks might look high-priced on the surface, but we believe they are more than worth every dollar we pay for them. The payoff comes in the strength and the reliability of their future growth.

Would you consider a stock that is considered growth at a reasonable price?

We actually spend little time looking at that. We let the market put the value it deems on stocks, and if the odds are in our favor, then the value on very high-quality stocks will still be cheaper than it should be. We are more concerned with consistency, and we prefer to see good momentum in the company's current operations.

What is your definition of risk? How do you manage it?

We find that investing in high-quality stocks just in and of itself puts the risk level of the portfolio exactly where we like it to be.

Notably, the fund's beta is well below that of its peers for every time period. By the way, its alpha is positive for each time period, while our peers' alpha is often negative.

The fund has a much lower standard deviation and a much higher Sharpe ratio than its peers, which tells you it is generating a lot of bang for the buck, a lot of return per unit of risk.

Finally, the upside-downside capture measurements are very interesting. In months when the stock market is rising, the fund captures somewhat less of the upside than our peers. It's in the down markets that our strategy pays off; in the months when the stock market is falling the fund captures much, much less of the downside than its peers. Of course that's exactly what we want to see. And that's the secret to this fund's long-term success. T

Value Line Small Cap Opportunities Fund

Company	Value Line Funds
Symbols	VLEOX (Inv Shares)
	VLEIX (Inst Shares)
Address	7 Times Square, 21st Floor
	New York, NY 10036
Phone	212-907-1878
Website	www.vlfunds.com

Source: Company Documents

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Value Line Small Cap Opportunities Fund *(VLEOX/VLEIX)*

Performance (as of 3/31/17)					
	Average Annual Returns				
	QTD	1 Year	3 Year	5 Year	10 Year
Investor - VLEOX	**3.90%**	**19.09%**	**8.62%**	**13.17%**	**8.25%**
Institutional - VLEIX[1]	**3.96**	**19.38**	***8.75***	***13.25***	***8.29***
Russell 2000 Index	2.47	26.22	7.22	12.35	7.12
Morningstar Small Growth Category Avg.	5.56	22.41	5.34	10.73	7.31
Morningstar Category Rank (%) - VLEOX		**80**	**15**	**9**	**26**
# of Funds in Category		670	599	527	386
Morningstar Return			**Above Avg.**	**Above Avg.**	**Above Avg.**
Morningstar Risk			**Low**	**Low**	**Low**
VLEOX Gross Expense Ratio: 1.25%, VLEIX Gross/Net Expense Ratio*: 3.47% / 1.00%					

Morningstar rates funds based on enhanced Morningstar risk-adjusted returns. Morningstar Ratings and Rankings based on Investor class shares.

[1]Indicates Morningstar Extended Performance. Extended performance is an estimate based on the performance of the fund's oldest share class, adjusted for fees. The Inception Date of (VLEIX) is November 1, 2015.

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed may be worth more or less than their original cost. Past performance data through the most recent month end is available at vlfunds.com or by calling 800.243.2729. You should carefully consider investment objectives, risks, charges and expenses of Value Line Mutual Funds before investing. This and other information can be found in the fund's prospectus and summary prospectus, which can be obtained free of charge from your investment representative, by calling 800.243.2729, or by clicking on the applicable fund at www.vlfunds.com. Please read it carefully before you invest or send money.

The average annual returns shown above are historical and reflect changes in share price, reinvested dividends and are net of expenses. Investment results and the principal value of an investment will vary.

There are risks associated with investing in small and mid cap stocks, which tend to be more volatile and less liquid than stocks of large companies, including the risk of price fluctuations.

As of 3/31/17, the Fund's Top 10 Holdings were as follows: Lennox International, Inc. (2.7%); Toro, Co. (2.5%); Middleby Corp. (2.2%); Waste Connections, Inc. (2.1%); HEICO Corp. (2.1%); Teledyne Technologies, Inc. (2.0%); Tyler Technologies, Inc. (2.0%); Pool Corp. (1.8%); Healthcare Services Group, Inc. (1.6%); RLI Corp. (1.6%).

*EULAV Asset Management (the "Adviser") and EULAV Securities LLC, the Fund's principal underwriter (the "Distributor"), have agreed to waive certain class-specific fees and/or pay certain class-specific expenses incurred by the Institutional Class so that the Institutional Class bears its class-specific fees and expenses at the same percentage of its average daily net assets as the Investor Class's class-specific fees and expenses (excluding 12b-1 fees and any extraordinary expenses incurred in different amounts by the classes) during the period March 17, 2016 through July 31, 2017 (the "Expense Limitation"). The Adviser and the Distributor may subsequently recover from assets attributable to the Institutional Class the reimbursed expenses and/or waived fees (within 3 years after the fiscal year end in which the waiver/reimbursement occurred) to the extent that the Institutional Class's expense ratio is less than the Expense Limitation. The Expense Limitation can be terminated or modified before July 31, 2017 only with the agreement of the Fund's board. The Fund's performance would be lower in the absence of such waivers.

The inception dates of Value Line Mutual Funds range from 1950 to 2016. **Value Line Mutual Funds are distributed by EULAV Securities LLC. Past performance is no guarantee of future results.**

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