

Mairs & Power Small Cap Fund MSCFX

Analysis

A unique, well-run fund.

By Tony Thomas 4/10/2018

The Mairs & Power Small Cap version of the firm's proven investing approach produces a distinctive, prudently managed fund with a respectable track record, earning a Morningstar Analyst Rating of Silver.

Lead manager Andy Adams has led the fund since its 2011 inception. He and comanager Al Steinkopf put a twist on their firm's cautious investing approach. Like other Mairs & Power managers, they prefer companies based near their St. Paul, Minnesota office where their access to management, employees, and the local community gives their fundamental research an edge. They like high-quality, well-managed companies with durable competitive advantages and above-average returns on equity. The twist is that they will be flexible with small companies that are reinvesting capital to grow their competitive advantages.

This unique approach has helped the fund hold its own against a higher-quality benchmark and outpace many of its peers. Unlike most of their small-blend Morningstar Category peers, Adams and Steinkopf pegged their fund to the more selective S&P SmallCap 600 Index. Their fund's 16.4% annualized total return from inception through March 2018 kept pace with the index, but that was enough to beat 98% of its peers. Furthermore, the fund has offered some downside protection versus its benchmark, which could be an advantage over a full market cycle.

The managers have been careful stewards of investors' money. They closed the fund to new investors in October 2016 after total assets grew from \$185 million to more than \$330 million in the first nine months of 2016, opting to protect current investors instead of branching into lower-quality prospects or risking illiquidity.

A strong investment culture at Mairs & Power is key to the managers' success. Adams, who became the firm's CIO in January 2018, joins

Steinkopf on the 12-person investment committee that oversees its products. The committee's conservative, low-turnover investment approach is time-tested, and Adams and Steinkopf have adapted it well to the small-cap space.

Process Pillar: Positive

Managers Andy Adams and Al Steinkopf tailor their firm's proven investment philosophy to the demands of the small-cap space. Their prudent adjustments earn this fund a Positive Process rating.

Like all Mairs & Power managers, Adams and Steinkopf look for good companies with effective management and durable competitive advantages, many of which are based in the Upper Midwest. They also seek firms with above-average returns on equity; however, they recognize that some good small caps reinvest their profits to grow market share or enhance their competitive position. To capture this kind of business spending, the team emphasizes returns on invested capital in its fundamental analysis of small-cap companies. Prospective investments--and the portfolio itself--face regular scrutiny from the firm's investment committee, which includes Adams, Steinkopf, and 10 other investment professionals.

The team is mindful of position sizes and liquidity issues when trading in small-cap stocks. They do not want to own more than 10% of a company, and they typically keep individual positions under 4% of total assets. Adams and Steinkopf showed prudence when large inflows in 2016 threatened to force them into less-desirable names or to top up on low-volume stocks, thereby increasing liquidity risk. They closed the fund to new investors in October 2016.


The Mairs & Power method favors company visits and community contacts in the search for prospects. That's valuable in the small-cap space, where company news and access can be limited. The managers have packed the portfolio with local firms. Three fourths of the fund's assets are in firms based in the Upper Midwest--the highest of

Morningstar's Take

Morningstar Analyst Rating



Morningstar Pillars

Process	 Positive
Performance	 Positive
People	 Positive
Parent	 Positive
Price	 Positive

Morningstar Analyst Rating

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum



Fund Performance

	Total Return %	+/- Category
YTD	-1.86	-2.14
2017	7.64	-4.64
2016	27.27	6.49
2015	-4.68	0.70
2014	6.73	2.94

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Analysis

the three Mairs & Power funds. One recent addition, Calyxt CLXT, typifies the managers' unique process. Calyxt uses agricultural gene-editing tools developed at the University of Minnesota. Though the new firm has negative returns on capital, the Mairs & Power team bought in based on its hometown insights and research into Calyxt's long-term growth potential.

The fund resembles its siblings with its sizable industrials stake, but its healthcare stake is less pronounced, and tech plays a slightly greater role. Even so, the fund has an underweighting in technology relative to its S&P SmallCap 600 Index benchmark. The portfolio's turnover rate in 2016 was 19%--also the highest of the firm's funds but well below the small-blend category average of 63%.

The managers' focus on returns on invested capital doesn't translate to a high ROIC relative to peers, but they haven't compromised on quality. More than 85% of firms in their December 2017 portfolio were profitable in their most recent fiscal year.

Performance Pillar: + Positive

This fund's respectable risk/reward profile since its inception, despite an unimpressive 2017, earns it a Positive Performance rating.

Lead manager Andy Adams got off to a fast start after the fund's August 2011 inception. The fund rose over 30% in 2012 and finished near the top of its small-blend category for the year. Since inception, the fund's 16.4% annualized total return through March 2018 easily beat its 12.8% peer average. Its prospectus benchmark, the S&P SmallCap 600 Index, is more selective than the Russell 2000 Index, making it a more difficult hurdle to clear. Even so, the fund's tally matched its benchmark and surpassed the Russell 2000 by over 2 percentage points over the period. The fund has also shown some downside protection thanks to its conservative approach, falling only 90% as far as the benchmark in downturns and posting in-

line risk-adjusted returns (as measured by the Sortino ratio) since its launch.

The fund's disappointing 2017 was to be expected given the managers' process. As a small-cap fund that tends to be light on technology, it missed the year's large-cap tech rally. Meanwhile, the managers' industrials and consumer cyclicals picks, often based in the Upper Midwest, also languished. Minnesota-based Tile Shop Holdings TTS fell nearly 70% in the 15 months ended March 2018 because of reduced margins and management changes.

People Pillar: + Positive

This team works well together and fits nicely within its firm's investment culture, earning the fund a Positive People rating.

The team is led by Andy Adams, a small-cap specialist who began pitching the fund soon after arriving at Mairs & Power in 2006 and has managed it since its August 2011 inception. Adams came to Mairs & Power from U.S. Bancorp Asset Management (now Nuveen Asset Management), as have several other partners at the firm. In addition to his work here, he has comanaged Mairs & Power Growth MPGFX, the firm's flagship fund, since January 2015. He was named the firm's CIO in January 2018. He has aligned his interests with shareholders', investing between \$500,000 and \$1 million in this fund and a similar amount in Mairs & Power Growth.

While Adams is ultimately responsible for portfolio decisions, he collaborates with Al Steinkopf, who joined the firm in 2013. Steinkopf had worked alongside Adams on small-cap core strategies at U.S. Bancorp/Nuveen. He became comanager here in 2015 and has between \$100,001 and \$500,000 invested in the fund.

Adams and Steinkopf work closely with the firm's 10 other investment professionals on an investment committee that monitors purchase and sale decisions across the funds. The committee contrib-

utes to an integrated investment culture at the firm by providing peer-review and idea-sharing opportunities.

Parent Pillar: + Positive

Mairs & Power Inc. is a small firm that stands out for its conservative investment philosophy and history of smooth leadership transitions. A spate of recent personnel changes creates some uncertainty, but the firm retains its Positive Parent rating.

A key retirement led to a series of moves. Chairman and CEO Jon Theobald stepped away at the end of 2017. Mark Henneman, lead manager of Mairs & Power Growth MPGFX and formerly the firm's president and CIO, moved into Theobald's place. Henneman's duties were then split: Andy Adams, the lead manager of Mairs & Power Small Cap MSCFX and comanager on Mairs & Power Growth, became CIO; and Rob Mairs, a descendant of the firm's founder, became president. Mairs is a former lawyer who came to the firm in 2015 to prepare for his leadership role. The magnitude of these changes and Mairs' relatively short tenure raise eyebrows, but the firm deserves praise for anticipating these moves and telegraphing its plans in advance.

The firm's investment culture provides some stability. Twelve investment professionals form a committee that promotes the core tenets of Mairs & Power's philosophy. Their preference for buying and holding quality companies that have durable competitive advantages, along with their ongoing relationships with companies--particularly near their St. Paul, Minnesota home--gives this firm an edge in fundamental analysis.

Price Pillar: + Positive

Below-average fees on this fund's only share class earn it a Positive Price rating, although the fund remains closed to new investors.

The fund's 1.05% expense ratio is attractive

Mairs & Power Small Cap Fund MSCFX

Analysis

versus other small-cap, no-load funds. It is below the group's 1.17% median expense ratio, making it cheaper than two thirds of its peers. The managers' low-turnover investment style also keeps brokerage costs down.

The firm closed the fund to new investors in October 2016, stifling flows and protecting the managers' ability to invest where and when they want.

Morningstar 2018 Analyst Report: Mairs & Power Small Cap Fund (MSCFX)

The Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus and summary prospectuses contain this and other important information about the Funds, and may be obtained by calling Shareholder Services at (800) 304-7404 or by visiting www.mairsandpower.com. Read the prospectus and summary prospectuses carefully before investing.

Performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Funds may be lower or higher than the performance quoted. As of the prospectus dated April 30, 2017, Mairs & Power Growth Fund, Mairs & Power Balanced Fund, and Mairs & Power Small Cap Fund have annual expense ratios of 0.66%, 0.72%, and 1.05%, respectively. For the most recent month-end performance figures, visit the Funds' website at www.mairsandpower.com or call Shareholder Services at (800) 304-7404.

Average Annual Total Returns for Periods Ending March 31, 2018

	<u>YTD</u> ⁽¹⁾	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>	<u>20 Years</u>	<u>Since Inception</u>
Mairs & Power Growth Fund ⁽²⁾	-4.07	6.31	7.43	10.37	9.48	8.97	11.27
Mairs & Power Balanced Fund ⁽²⁾	-3.59	4.62	5.14	6.95	7.66	7.13	9.53
Mairs & Power Small Cap Fund ⁽²⁾	-3.28	1.48	7.17	10.12	N/A	N/A	16.39
S&P 500 Total Return (TR) Index ⁽³⁾	-0.76	13.99	10.78	13.31	9.49	6.46	N/A
Composite Index ⁽⁴⁾	-1.01	8.89	7.00	8.72	7.43	6.14	N/A
S&P 600 Small Cap Total Return (TR) Index ⁽⁵⁾	0.57	12.68	10.76	13.56	N/A	N/A	N/A

⁽¹⁾ Not annualized

⁽²⁾ Performance information shown includes the reinvestment of dividend and capital gain distributions, but does not reflect the deduction of taxes that a shareholder would pay on Fund distributions or the redemption of Fund shares.

⁽³⁾ The S&P 500 TR Index is an unmanaged index of 500 common stocks that is generally considered representative of the U.S. stock market. It tracks both the capital gains of a group of stocks over time and assumes that any cash distributions, such as dividends, are reinvested back into the index. It is not possible to invest directly in an index.

⁽⁴⁾ The Composite Index reflects an unmanaged portfolio of 60% of the S&P 500 TR Index and 40% of the Bloomberg Barclays U.S. Government/Credit Bond Index. It is not possible to invest in an index.

⁽⁵⁾ The S&P SmallCap 600 Total Return Index is an index of small-company stocks managed by Standard & Poor's that covers a broad range of small cap stocks in the U.S. The index is weighted according to market capitalization and covers about 3-4% of the total market for equities in the United States. It tracks both the capital gains of the group of stocks over time and assumes that any cash distributions, such as dividends, are reinvested back into the index. It is not possible to invest directly in an index.

The statements and opinions are those of the author as of the date of this report. All information is historical and not indicative of future results and subject to change. The reader should not assume that an investment in the securities mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance is not indicative of future results.

All investments have risks. The Funds are designed for long-term investors. Equity investments are subject to market fluctuations and the Fund's share price can fall because of weakness in the broad market, a particular industry or specific holdings. Investments in small and midcap companies generally are more volatile. International investing risks include among others political, social or economic instability, difficulty in predicting international

trade patterns, taxation and foreign trading practices and greater fluctuations in price than U.S. corporations. The Balanced Fund is subject to yield and share price variances with changes in interest rates and market conditions. Investors should note that if interest rates rise significantly from current levels, bond total returns will decline and may even turn negative in the short-term. There is also a chance that some of the Balanced Fund's holdings may have their credit rating downgraded or may default. The Small Cap Fund may invest in initial public offerings by small cap companies, which can involve greater risks than investments in companies that are already publically traded.

As of 3/31/2018, the Small Cap Fund has an overall Morningstar Rating of 3 stars and 3 stars and 3 stars for the 3- and 5-year periods among 627, 627 and 542 small blend funds based on Morningstar Risk-Adjusted Return. The Morningstar Rating for funds, or star rating, is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are 100% three-year rating for 36-59 months of total returns, 60% five-year rating, 40% three-year rating for 60-119 months of total returns, and 50% 10-year rating, 30% five-year rating, 20% three-year rating for 120 or more months of total returns. While the 10-year overall rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Copyright 2018, Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

The stocks mentioned herein represent the following percentages of the total net assets of the Mairs & Power Small Cap Fund as of March 31, 2018: Calyxt Inc. 0.67%, Tile Shop Holdings, Inc. 1.32%, U.S. Bancorp 0.00%, Nuveen 0.00%. All holdings in the portfolio are subject to change without notice and may or may not represent current or future portfolio composition. The mention of specific securities is not intended as a recommendation or offer for a particular security, nor is it intended to be a solicitation for the purchase or sale of any security.

As of 3/31/2018, the risk adjusted return rank for the Mairs & Power Small Cap Fund Rank is 98 for 1-year, 57 for 3-year, and 63 for 5-year, based on 781, 627, and 542, respectively, in the Small Blend Category by Morningstar.

Return on invested capital (ROIC) is the percentage return that a company makes over its invested capital.

Sortino ratio measures the risk-adjusted return of an investment asset, portfolio or strategy by calculating the excess return over the risk-free rate divided by the downside semi-variance.

The Russell 2000 Index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. It is not possible to invest directly in an index.

Return on equity (ROE) is a measure of profitability that calculates how many dollars of profit a company generates with each dollar of shareholders' equity.

ALPS Distributors, Inc. is the Distributor for the Mairs & Power Funds.