

Mairs & Power Small Cap Fund MSCFX

Analysis

An old-fashioned firm's newest fund is off to a fast start.

By Tony Thomas 4/20/2017

Mairs & Power Small Cap is the newest fund in the Mairs & Power lineup, playing minor variations on the firm's proven investing theme. The result is a distinctive fund that's managed with prudence, earning a Morningstar Analyst Rating of Silver.

Lead manager Andy Adams has been in charge since the fund's inception in 2011. He and co-manager Al Steinkopf put a twist on their firm's cautious investing approach. They prefer companies based near their St. Paul, Minnesota office because they believe that access to management, employees, and the local community gives their fundamental research an edge. They like high-quality companies with good management, durable competitive advantages, and above-average returns on equity. The twist is that they will grant leeway to small companies that are reinvesting returns to grow their competitive advantages. Strong stock-picking has given the fund a solid risk/reward profile. For the five years ended March 2017, the fund was less volatile than 80% of its small-blend Morningstar Category peers, but its annualized returns are among the best in the class.

The managers have been careful stewards of investors' money. They closed the fund to new investors in September 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.

The strong investment culture at Mairs & Power promotes success here and at the firm's two other funds: Mairs & Power Balanced MAPOX and Mairs & Power Growth MPGFX. Adams also co-manages the growth fund with Mark Henneman, the firm's CIO. He was providing small-cap picks for the fund when Henneman and former longtime manager Bill Frels were named Morningstar Domestic-Stock Fund Manager of the Year in 2012. Henneman

thinks the firm's current lineup is well-rounded, and he expects Adams and Steinkopf to run a topnotch fund that feeds prospects to the firm's other managers. This integrated approach is paying off. All three funds have attractive risk/reward profiles.

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. 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, Steinkopf emphasizes returns on invested capital in his 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 eight 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 recognized that large inflows in 2016 might force them to add less-desirable names or top up on low-volume stocks, thereby increasing liquidity risk. In response, they moved to protect the fund's shareholders by closing to new investors in September 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. More than 80% of the names in the portfolio are based in the Upper Midwest—the

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

 Gold  Silver  Bronze **Neutral**  Negative

Fund Performance

	Total Return %	+/- Category
YTD	3.86	0.71
2016	27.27	6.49
2015	-4.68	0.70
2014	6.73	2.94
2013	38.75	1.36

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highest of the three Mairs & Power funds. The fund resembles its siblings with its sizable stake in industrials, but its healthcare stake is less pronounced. Tech stocks play a greater role here than at the other Mairs & Power funds, though the fund remains underweight in the sector relative to its benchmark and peer average. The portfolio's turnover rate in 2016 was 21%--also the highest of the Mairs & Power funds but well below the category average of 64%.

The fund benefited from merger and acquisition activity during 2016. Takeover targets like Private-Bancorp PVTB and G&K Services, a Minnesota-based renter of uniforms, attracted premium offers. Other holdings added value through strategic acquisitions, like Great Western Bancorp GWB and Apogee Enterprises APOG, which coats glass for high-rise buildings.

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 90% of firms in their portfolio were profitable during the 12 months ended March 2017.

Performance Pillar: Positive

This fund has generated a strong risk/reward profile in its short existence, earning it a Positive Performance rating.

From its inception in August 2011 through March 2017, the fund's 18.2% annualized return trounced the average small-blend category peer. The fund bests its benchmark S&P SmallCap 600 Index during the same period by nearly 220 basis points annually. This outstanding performance hasn't come with excessive volatility. The fund's standard deviation is close to the benchmark's, and its Sortino ratio--a measure of returns relative to downside risk--is a healthy 2.20 during the period.

The portfolio's tilt toward industrials detracted in 2015, but the managers' patience with these stocks paid off when they bounced back in 2016. The same patience will be necessary for the portfolio's current weak spot: technology stocks. This

fund's tech-sector weighting is larger than its Mairs & Power siblings', and stock selection here has hurt of late. Firms like Cray CRAY and Vasco Data Security International VDSI dragged on performance during the 15 months ended March 2017. But the managers' long-term approach has eased the pain: both stocks have more than doubled since entering the portfolio more than five years ago. The managers added to both positions toward the end of 2016.

People Pillar: Positive

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. Al Steinkopf joined as a comanager in 2015 and provides support in small-cap research. The team works well together and fits within the firm's investment culture, earning a Positive People rating.

Adams came to Mairs & Power from U.S. Bancorp Asset Management (now Nuveen Asset Management), as have several other partners at the firm. He has been a significant small-cap resource from the start, and in January 2015 he was named comanager of Mairs & Power Growth MPGF, the firm's flagship fund. He has aligned his interests with shareholders', investing \$500,000-\$1 million in this fund, and an additional \$100,000-\$500,000 in Mairs & Power Growth.

While Adams is ultimately responsible for portfolio decisions, he collaborates with Steinkopf, who joined the firm in 2013. Steinkopf had worked alongside Adams on small-cap core strategies as U.S. Bancorp/Nuveen. Steinkopf is also invested in the fund.

Adams and Steinkopf work closely with the firm's eight other investment professionals on an investment committee that monitors purchase and sale decisions across the funds. The committee contributes to an integrated investment culture at the firm by providing peer-review and idea-sharing opportunities.

Parent Pillar: Positive

The success of the Mairs & Power funds reflects

the conservative investment philosophy and steady leadership of their advisor, Mairs & Power Inc., earning a Positive Parent rating. The firm's 10 investment professionals form a committee that promotes the core tenets of Mairs & Power's philosophy. They favor buying and holding quality companies that have durable competitive advantages and above-average returns on equity. They prefer companies based near their St. Paul, Minnesota home, believing that ongoing relationships with management and employees give them an edge in fundamental analysis.

The 86-year-old firm had an orderly transition of power when longtime fund manager and CEO Bill Frels ceded his lead manager duties on the Balanced and Growth funds 18 months before his retirement at the end of 2014. Current chairman and CEO Jon Theobald will retire at the end of 2017, with CIO and fund manager Mark Henneman being groomed as his replacement.

There's no rush here to put out new offerings. For more than 50 years, the firm offered just two mutual funds: the flagship Mairs & Power Growth MPGF, launched in 1958, and Mairs & Power Balanced MAPOX, launched in 1961. The launch of Mairs & Power Small Cap MSCFX in 2011 built upon the team's growing small-cap expertise. Reasonable fees and strong track records add to the attraction of the Mairs & Power lineup.

Price Pillar: Positive

The fund's Investor shares--the only share class offered for the Mairs & Power funds--sport below-average fees compared with small-cap no-load funds. This fund isn't as good a bargain as its Mairs & Power siblings, but its fees are reasonable for a fund with modest assets under management. Low turnover should keep trading costs to a minimum and taxes in check. The fund closed to new investors in September 2016 in order to keep flows manageable for investing in the small-cap space.

Morningstar 2017 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 June 30, 2017

	<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⁾	7.91	12.13	7.79	14.09	8.05	9.66	11.36
Mairs & Power Balanced Fund ⁽²⁾	5.49	8.48	5.32	9.76	6.78	7.97	9.62
Mairs & Power Small Cap Fund ⁽²⁾	4.73	19.16	8.69	15.87	N/A	N/A	18.78
S&P 500 Total Return (TR) Index ⁽³⁾	9.34	17.90	9.61	14.63	7.18	7.15	N/A
Composite Index ⁽⁴⁾	6.64	10.29	6.91	9.67	6.45	6.75	N/A
S&P 600 Small Cap Total Return (TR) Index ⁽⁵⁾	2.79	22.47	9.32	15.47	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 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.

The stocks mentioned herein represent the following percentages of the total net assets of the Mairs & Power Small Cap Fund as of June 30, 2017: Apogee Enterprises, Inc. 3.62%, Cray Inc. 1.76%, G&K Services 0.00%, Great Western Bancorp 3.12%, PrivateBancorp, Inc. 0.00%, VASCO Data Security International, Inc. 0.24%. 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.

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

Standard Deviation is a measure of the dispersion of a set of data from its mean.

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

MNP000921 10/31/2017