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High Pointe

DATE: January 15, 2008
TO: Clients
FROM: Gautam Dhingra
RE: Fourth Quarter 2007 Review

Economic Environment

The S&P 500 Index finished the year with a modest return of 5.5%, following a market pullback during November and December. It was a highly turbulent year in which financials and consumer-oriented stocks declined precipitously, and stocks with high free cash flows substantially underperformed those with strong price momentum.

We acknowledged the effectiveness of price momentum in our second quarter 2006 newsletter to clients, but we underestimated its longevity and intensity. Price momentum continued to strengthen throughout the year, reaching its pinnacle between September and December during which time positive momentum stocks outperformed negative momentum stocks by 24%.

Our investment process identifies stocks that are selling inexpensively in light of their growth and asset quality characteristics. It does not focus on price momentum, and typically we are willing to buy stocks with negative price momentum if fundamental valuation is attractive. The natural question is this: If momentum has been the best factor in recent quarters, should we change our investment approach to emphasize it? The answer is a resounding “no” for two reasons.

The trend is your friend, until it isn't.

First, research has shown that most of the profit at the individual stock level resulting from price momentum signals is garnered during the first two to three months. This implies a holding period that is so short that it would result in higher costs for all investors and a higher tax burden for taxable investors.

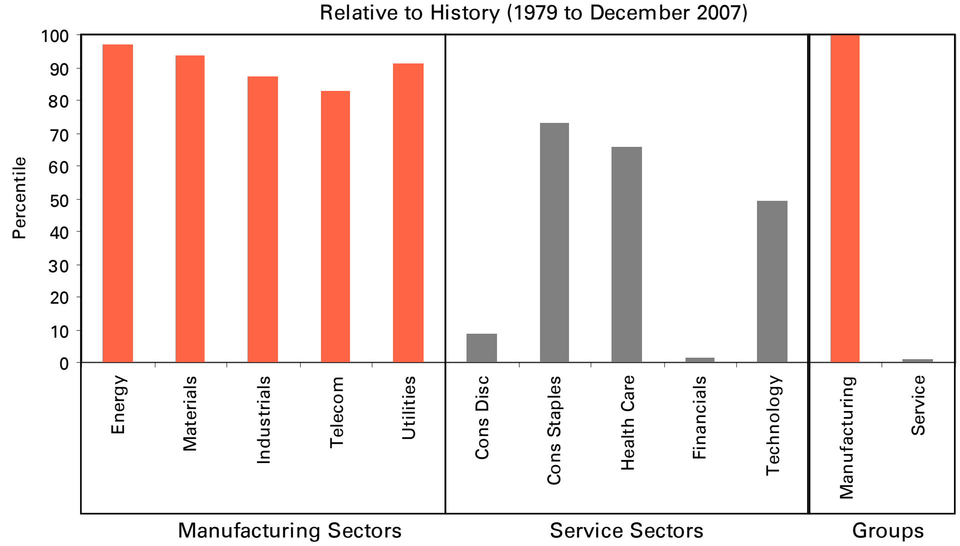
The second reason is the mean-reverting, cyclical nature of price momentum. By definition, price momentum must reverse over time; otherwise, positive momentum stocks would go to infinity and negative momentum stocks would go to zero. Historically, price momentum has only produced positive excess returns (relative to the market) for two- to three-year periods at a time. The current period is already in excess of three years.

So we must not cave in to the momentum wave; however, we should acknowledge momentum’s role from a risk control perspective. Accordingly, we are associating a higher short-term risk with extreme negative price momentum stocks and thus assigning them a lower weighting.

A second area of introspection for us as we look back at 2007 is our tendency to emphasize service-oriented industries. This tendency is a natural byproduct of our preference for companies with undervalued intangible assets. This strategy has been beneficial over the long run because the secular trend worldwide has been for service industries to outgrow manufacturing and commodity-related industries. However, recently this secular trend has been interrupted. For example in 2007, each manufacturing sector produced a 12-month return that ranked in the top 20% of rolling 12-month returns during the last three decades. Taken in aggregate, the manufacturing group produced its highest 12-month return in over 30 years (see chart below). Conversely, the financial and consumer discretionary sectors each produced bottom-decile returns, resulting in the lowest 12-month return for the service group during that last 30 years. As a result, manufacturing-oriented stocks outperformed service-oriented stocks by a whopping 32% during the year.

Last 12-Month Performance Percentile[1]

Relative to History (1979 to December 2007)



[1] (100 = highest; 1 = lowest)

This phenomenon is insightful in understanding the performance pattern of our large cap value strategy which is typically overweight service sectors and underweight commodity-oriented manufacturing sectors relative to the Russell 1000 Value Index. Our average historical overweight to service sectors has been about 20%. During 2007, our overweight increased to 34% due to the compelling valuations in information technology and health care sectors as well as corporate spin-offs. As the correlation of the sectors within the service and manufacturing groups increased during 2007, we modified our portfolio construction guidelines to achieve a higher level of diversification.

From a risk perspective, we believe it is appropriate to restrict the overweighting of the service group to no more than 20%, which is in line with our historical average overweight. We believe that the secular outperformance of service-oriented sectors will continue over the long run, though we acknowledge the short-term cyclical risks of commodity rallies.

To change and to change for the better are two different things.
– German Proverb

In summary, we have made two enhancements to our investment process in acknowledging the short-term risk of stocks with negative price momentum and in maintaining a more balanced mix of service and manufacturing sectors. These changes supplement our core investment approach, which is based on three well-defined and logical principles: 1) a stock's intrinsic value is best measured by evaluating its current price in the context of its asset quality and growth characteristics; 2) a well diversified but focused portfolio of stocks has the ability to add the most value over the long run; and 3) the recognition of intangible assets will continue to increase over time, perpetuating the secular outperformance of service-oriented sectors over the long run.

Investment Returns

The returns of our three main products are summarized below and a discussion of our investment strategy follows in the next section.

High Pointe Capital Management
Investment Performance (Net of Fees)[1]

For Periods Ending December 31, 2007

	4th Quarter	1 Year	3 Years	5 Years	7 Years	Since Inception[2]
Large Cap Value	-11.0%	-14.1%	1.1%	10.7%	7.0%	11.7%
Russell 1000 Value Index	-5.8%	-0.2%	9.3%	14.6%	6.7%	7.7%
Large Cap Growth	-6.5%	-0.7%	4.1%	13.3%	3.8%	9.2%
Russell 1000 Growth Index	-0.8%	11.8%	8.7%	12.1%	0.2%	-0.2%
Small Cap	-9.7%	-15.5%	1.5%	13.8%	11.4%	9.9%
Russell 2000 Index	-4.6%	-1.6%	6.8%	16.2%	8.1%	7.1%

[1]Performance for the latest quarter is preliminary and subject to change
[2]Inception Dates: Large Cap Value - January 1, 1998; Large Cap Growth – August 1, 1999; Small Cap – January 1, 1998.

Performance results are shown net of management fee, and are based on composites of all fee-paying, fully-discretionary accounts. Returns for the periods presented are time-weighted. Results shown include the reinvestment of dividends, capital gains and other earnings. The currency used to express performance is U.S. dollars. High Pointe's fee schedules are disclosed in Part II of the firm's Form ADV. All fully discretionary, fee-paying accounts have are included in at least one composite, and no accounts have been terminated since the inception of each of the composites. No alterations of the composites as presented in this report have occurred because of changes in personnel or for any other reasons at any time. The composite results portrayed during the period are compared to the performance of their respective indices because the securities purchased for each of the composites are most closely aligned with the securities comprising these indices.

High Pointe Capital Management, LLC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). A complete list of firm composites and performance results is available upon request. The CFA Institute has not been involved with the preparation or review of this report. Returns represent past performance and are not indicative of future results. Investment may result in the loss of principal.

*The unmanaged **Russell 1000 Value Index** measures the performance of those securities in the Russell 1000 Index having lower price-to-book ratios and lower forecasted growth values. The unmanaged **Russell 1000 Growth Index** measures the performance of those securities in the Russell 1000 Index having higher price-to-book ratios and higher forecasted growth values. The unmanaged Russell 1000 Index is comprised of 1,000 of the largest capitalized companies that are traded in the United States.*

*The unmanaged **Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index is comprised of the 3,000 largest U.S. companies based on total market capitalization.*

These indices do not reflect fees and expenses associated with the active management of separate account portfolios.

Investment Strategy

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of -11.0% during the fourth quarter, trailing the Russell 1000 Value Index by 5.2%. Weak stock selection in financials, telecommunication, and consumer discretionary positions more than offset positive stock selection in information technology and consumer staples sectors. An underweight to energy and utilities sectors also detracted value, as energy prices rose.

The softening U.S. economy contributed to weaker earnings guidance for our wireless telecommunication, cable, and consumer rental investments. In addition, our insurance holdings experienced asset write-offs resulting from weaker credit and mortgage markets.

We took steps during the quarter to reduce our underweight to manufacturing-oriented sectors. In financials, we sold several holdings with mortgage exposure prior to the severe drop in prices during November and invested the proceeds partially back into financial stocks with less sensitivity to mortgage markets and the rest into non-financial stocks.

We increased our exposure to industrials, favoring firms selling at a reasonable valuation with strong overseas operations that will benefit from growth outside the U.S. In doing so, we sold our data storage investment at a significant profit. For diversification purposes, we also reduced the health care sector allocation which had appreciated in value.

Large Cap Growth

High Pointe's Large Cap Growth product produced a return of -6.5% during the fourth quarter, trailing the Russell 1000 Growth Index by 5.7%. A lack of exposure to stocks with positive price momentum (often those selling at high P/E valuations) resulted in negative stock selection across the board. Sector selection was neutral overall, with an overweight to information technology and health care stocks offsetting underperformance resulting from an underweight to consumer staples and an overweight to telecommunication sectors relative to the Index.

Higher fuel prices contributed to the underperformance of our airline holding, while a perceived slowdown in future corporate spending on technology adversely affected our investments in network & communications, internet software & services, and data storage. We believe this risk is exaggerated given the ongoing worldwide need for investment in technology infrastructure.

During the quarter, several consumer, health care, and telecommunications positions were sold with proceeds invested in aerospace & defense, communication, business software & service, diversified computer systems, and staffing & outsourcing industries.

Small Cap

High Pointe's Small Cap product produced a return of -9.7%, which lagged the Russell 2000 Index by 5.1% during the last three months. The portfolio's current value orientation (relative to the Index) and lack of high momentum stocks led to negative stock selection in several sectors, including financials, health care, consumer, industrials, and information technology. Sector selection was slightly negative due to an overweight to the consumer discretionary sector and an underweight to the health care sector. An underweight to the financials sector was positive.

Our investments in life & health insurance, consumer finance, reinsurance, health care supplies, and health care equipment industries detracted the most value, while our holdings in energy added value, owing to strong results from drilling & exploration, equipment & services, and coal positions.

During the quarter, we repositioned the portfolio by lowering our exposure to consumer discretionary and financials sectors and increasing our investments in information technology, industrials, and energy stocks. In doing so, we increased the number of stocks in the portfolio with strong non-U.S. operations, and decreased the portfolio's overall sensitivity to the softening U.S. economy.

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While we maintain high conviction in our core investment process, we are not resting on the laurels of our long-term performance. We are adjusting to changing market conditions learning from our missteps and hope to deliver better results for our investors in and beyond 2008.