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High Pointe

DATE: July 14, 2009
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

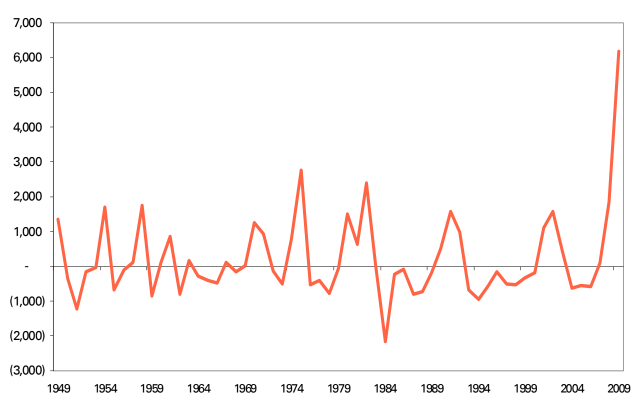
Cash for Clunkers

Cash for Clunkers is the popular name for a new government program which allows anyone with an old, inefficient car to get a voucher of up to $4,500 for buying a new, better quality car. This is one of the many programs started by the government to boost the public's confidence by demonstrating that the government is taking action to combat the economic downturn. The government's actions seem to have had at least some psychological impact as the fear that gripped the market after Lehman's failure in September 2008 has subsided. The fundamental economic news, however, continues to be grim.

The most worrisome news relates to unemployment. It is widely known that the unemployment rate is now approaching 10% and that job losses over the last 12 months have exceeded six million, the highest number in over 60 years (Exhibit 1). However, the following points are still underappreciated.

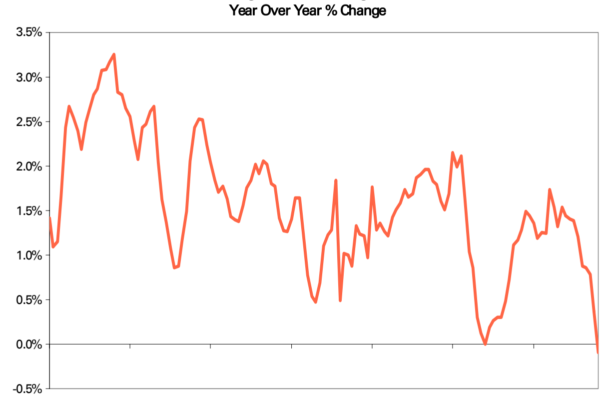
- A broader measure of unemployment which incorporates marginally attached workers and those working part time involuntarily is already at 16.8%, having jumped from 10.3% just a year ago. In other words, one in six Americans is unemployed or underemployed.
- Incomes are declining (Exhibit 2) because, in addition to outright unemployment, the number of hours worked per week is down sharply and salary increases have become hard to earn.
- The job losses in the current recession are substantially more of a permanent variety than in past recessions when workers were furloughed and then recalled once the recovery started.

Exhibit 1: Increase in Number of People Unemployed
Year over Year Difference (Thousands)



Source: Bureau of Labor Statistics

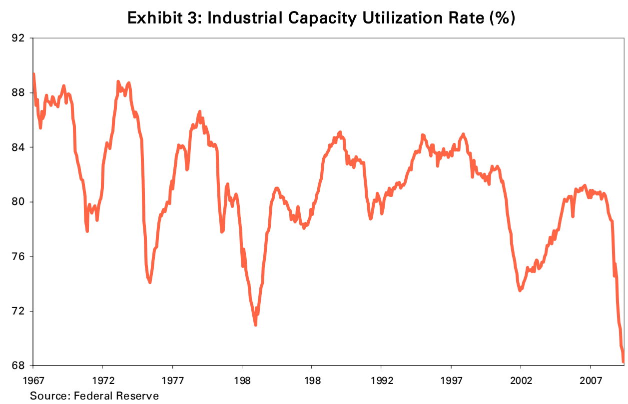
Exhibit 2: Change in Total Wages and Salaries
Year Over Year % Change



Source: Bureau of Economic Analysis

These adverse employment trends have eroded workers' ability to secure high prices (wages) for their services despite having their best friend in a long time in the White House.

Labor is not the only group without pricing power. Industrial companies are using only 68% of their total capacity (Exhibit 3), the lowest in sixty years. Such high level of excess capacity means that even when demand from customers recovers, there will be too much competition among suppliers. As a result, they will have limited pricing power and will be unable to earn high profits.



These data beg the following question: If labor (i.e., consumers') income is down and corporate (i.e., shareholders') income is likely to remain depressed, where will demand for products and services come from? Some people seem to be looking to the federal government to provide the demand, but the reality is that the federal government's share of the economy, at less than 15%, is small. Therefore, even a large increase in its spending is not enough to offset weakness in the private, state and municipal sectors.

In light of such downbeat economic data, it may appear surprising that stocks appreciated by 40% from early March to early June. However, that is just a reminder that *in the short run* there is not a strong relationship between the health of the economy and the health of the stock market. If stocks are already beaten up enough, they can bounce back even in the face of bad economic news. What is noteworthy is that the increase in stock prices during March – June 2009 has been entirely caused by an increase in valuations (i.e., an expansion of price-to-earnings ratios) rather than an increase in earnings.

Another interesting feature of the market's rise is that it has been led by "clunkers", i.e., low quality companies with weak balance sheets and unstable sales and earnings. The table below shows performance of companies of various qualities during 2009.

Exhibit 4: Stock Returns (January – June 2009)
Based on Merrill Lynch's Quality Sectors

Quality	A+	A	A-	B+	B	B-	C & D
Return	4.5%	-2.0%	3.3%	8.7%	22.5%	29.3%	58.4%

So, the market has been offering its own version of *Cash for Clunkers* program during 2009. In our opinion, this program is now exhausted. Valuations of low-quality companies are now too high in light of their weak characteristics and, correspondingly, high quality stocks are inexpensive. Therefore, we are using this opportunity to upgrade the quality of our portfolios by selling some of the clunkers that have served us well and buying higher quality companies that have more stable sales and earnings, strong balance sheets and reasonable valuations.

Our view is that *clunkers* break down on rough roads, and the road ahead does not look smooth to us.

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 June 30, 2009

	2nd Quarter	Year-to Date	Three Years	Ten Years	Since Inception[2]
Large Cap Value	14.8%	8.5%	-11.2%	5.8%	7.0%
Russell 1000 Value Index	16.7%	-2.9%	-11.1%	-0.2%	2.2%
Large Cap Growth	22.4%	20.7%	-4.3%	N/A	5,2%
Russell 1000 Growth Index	16.3%	11.5%	-5.5%	N/A	-3.9%
Small Cap	24.0%	20.1%	-9.9%	5.4%	6.4%
Russell 2000 Index	20.7%	2.6%	-9.9%	2.4%	2.6%

[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.

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 14.8% during the second quarter, underperforming the Russell 1000 Value Index by 1.9%. Favorable sector selection added value due to an underweight in telecommunications and an overweight to technology. This was offset by negative stock selection in financials and consumer discretionary sectors.

During the quarter, higher risk industries outperformed lower risk industries. This impacted the portfolio negatively, particularly in the financial sector where we had underweighted higher risk industries such as banks, securities brokers, investment bankers, life and health insurance industries, and overweighted lower risk industries, such as property and casualty insurance, and insurance brokers.

We reduced our exposure to health care and financials during the quarter and correspondingly increased industrials and consumer staples. Specifically, we replaced our investments in managed care and branded pharmaceuticals with a better opportunity in pharmaceuticals. In addition, within financials we sold our asset management and insurance broker positions and invested in large cap banks that had passed the government's "stress test" with flying colors.

Large Cap Growth
High Pointe's Large Cap Growth strategy produced a return of 22.4%, which was 6.1% ahead of its benchmark, the Russell 1000 Growth Index. The outperformance was largely driven by positive stock selection during the quarter in health care, technology, and consumer staples sectors. Specifically, our investments in health care equipment, electronic manufacturing, and biotechnology added the most value. Sector selection was mixed with an overweight to financials adding value and an overweight in health care detracting value.

During the quarter we increased our investments in the consumer discretionary sector with proceeds from financials. In particular, we realized profits in the asset management industry as our positions reached their price targets and invested in opportunities in automotive retail and for-profit education industries. We also repositioned our investments within the consumer staples sector, replacing our soft drink and drug retail investments with companies that are leaders in tobacco and discount retailing businesses.

Small Cap
High Pointe's Small Cap strategy produced a return of 24.0%, putting it ahead of the benchmark, the Russell 2000 Index, by 3.3% for the quarter. Security selection was strong during the quarter, especially in financials, health care, and industrials sectors. Our investments in asset management, biotechnology, and heavy construction added the most value. Sector selection also added value benefiting from an underweight to utilities and an overweight to energy.

During the quarter, we increased our allocation to the consumer discretionary sector and correspondingly decreased our investments in financials and consumer staples. We took profits from our asset management and property and casualty insurance investments, as they had reached our price targets, and invested the proceeds in education services, rent-to-own retail, media and casino industries.

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We are pleased with strong performance this year both in absolute terms as well as relative to the benchmarks, and look forward to reporting our third quarter results to you in October. Thank you for the opportunity to manage your assets. Please call me if you have questions.