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High Pointe

DATE: January 19, 2011
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Jeopardy

Alex Trebek: "Our final category today is 'Famous Bens' and the answer is 'He is an inventor, an expert at running printing presses and is featured on money'. Ken, who is this famous person?
Ken Jennings: "Who is Ben Franklin?"
Alex (smugly): "No, I am sorry, Ken. Ben Franklin is the old correct answer. The new correct answer is Ben Bernanke."

We are living in extraordinary economic times even if we do not realize it yet. This is not a run-of-the-mill recession and recovery. Our government and our central bank have taken extreme measures to counter low confidence, slow economic growth, deflation risk, high unemployment, and declining home prices. The "battle" for confidence has been won, progress has been made on economic growth and deflation, but there are no achievements worth noting when it comes to unemployment and declining home prices. And, of course, the "war" is unfinished on all fronts.

When the financial crisis unfolded in 2007, the authorities took two conventional measures to stem the tide. One was to lower short-term interest rates and the second was to spend government (really taxpayers') money to stimulate demand for goods and services. When these two steps proved inadequate the Federal Reserve Bank undertook an unorthodox third step. It "printed" new money and bought bonds with that money in the hope that this would lower long-term interest rates, generate economic growth and improve confidence.

The approach seemed to work well from early 2009 to early 2010 as economic activity increased, confidence returned, and housing prices and unemployment stabilized. However, as the summer of 2010 rolled on, dark clouds were on the horizon again. So, the Fed embarked on another round of printing money and buying bonds. Explaining his actions, he published an editorial in The Washington Post on November 3, 2010, excerpts of which are revealing and quoted below.

> *". . . Notwithstanding the progress that has been made . . . [the Fed] met this week to review the situation and we could hardly be satisfied. . . . [The Fed] decided this week that with unemployment high and inflation very low, further support to the economy is needed . . . by purchasing additional $600 billion of longer-term securities. . . . This approach eased financial conditions in the past . . . Stock prices rose and long-term interest rates fell . . . lower mortgage rates will make housing more affordable and allow more homeowners to*

> *refinance. . . . And higher stock prices will boost consumer wealth and help increase confidence which can also spur spending."*

It is not at all common for central bankers to adopt and admit a policy of propping up stock prices. The reason Mr. Bernanke has had to invent these schemes to support the economy is that the private sector refuses to take the baton from the public sector for generating economic growth. The private sector is profit driven and it does not believe it can earn strong returns on capital to justify lending and investing.

So, this scenario is evolving as a litmus test of government power over economic affairs. Can Mr. Bernanke will (and print) his way to economic growth by convincing the private sector that it is safe and profitable to spend its cash hoard? Recent data points on this matter are mixed at best. Unemployment continues to be uncomfortably high and home prices are starting to decline again. Moreover, contrary to the Fed's expectations, interest rates have risen instead of declining since the new round of action was initiated by the Fed.

Mr. Bernanke is playing the role of a cheerleader very well. For example, in a speech at the FDIC Forum on January 11, 2011 he took credit for higher stock prices while minimizing the unwelcome development of higher long term interest rates. He said *"Our policies have contributed to a stronger stock market just as they did in March 2009 when we did the first iteration of this program . . . Interest rates are higher but that's mostly because the news is better. It has responded to a stronger economy and better expectations."*

Frankly, it is hard to blame Mr. Bernanke for being a cheerleader because that is in fact the role of a General leading an army in a war. Which General was ever successful in winning battles by giving his troops an honest and balanced view of their chances of victory! Another reason not to blame Mr. Bernanke's approach is that there are no clear superior alternatives to what he is doing. We are simply caught between a rock and a hard place, and experimenting to find a way out of it.

So, the game Mr. Bernanke is playing is more like Roulette than Jeopardy. Hard work and knowledge can ensure a win at Jeopardy. In Roulette, it depends on the roll of the dice. Mr. Bernanke might succeed but his chances of success are much lower than those of Ken Jennings in Jeopardy.

Regardless of whether Mr. Bernanke is able to lead us out of trouble or is sacrificed along the way, investors should position their portfolios to survive and thrive as outlined below.

Recent Events	Implications for Investors
Unprecedented Government Debt	Diversify into non-dollar assets to protect against the long term decline of the dollar
Deleveraging by private sector leading to economic growth	Emphasize non-cyclical stocks, deemphasize consumer discretionary stocks
Higher "fat tails" risk, i.e., higher risk of extreme economic events	Emphasize higher quality investments
Currency wars	Have some exposure to real, and not just financial, assets

Investment Returns

The returns of our 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, 2010

	4th Quarter	One Year	Three Years	Ten Years	Since Inception[2]
Small Cap	11.5%	17.8%	6.0%	9.7%	9.0%
Russell 2000 Index	16.3%	26.9%	2.2%	6.3%	5.9%
Large Cap Value	9.7%	12.8%	-0.3%	4.8%	8.8%
Russell 1000 Value Index	10.5%	15.5%	-4.4%	3.3%	4.8%
Large Cap Growth	11.3%	7.9%	-0.4%	2.5%	6.6%
Russell 1000 Growth Index	11.8%	16.7%	-0.5%	0.0%	-0.3%
International Equity	6.0%	7.4%	-2.4%	N/A	0.1%
MSCI All Country World ex US Index	7.2%	11.2%	-4.7%	N/A	0.3%

[1]Performance for the latest quarter is preliminary and subject to change
[2]Inception Dates: Small Cap – January 1, 1998; Large Cap Value - January 1, 1998; Large Cap Growth – August 1, 1999; International Equity – December 31, 2006.

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 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.*

*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 **MSCI All Country World ex-U.S. Index** measures the equity market performance of world's developed and emerging markets. As of June 2009 the index consisted of 44 countries (22 developed and 22 emerging countries).*

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

Investment Strategy

Small Cap

High Pointe's Small Cap strategy produced a return of 11.5% during the quarter, trailing the Russell 2000 Index by 4.8%. During the quarter, security selection in the technology and consumer discretionary sectors detracted value.

After outperforming for much of the year, our optical networking investment experienced a hiccup during the fourth quarter. Since then we have scaled back our investment in the industry. Some of our investments in the biotech industry lagged last quarter as money gravitated towards cyclical stocks benefitting from the Fed's mission to supply more money to the market. We continue to view the biotech industry positively as it offers many opportunities to invest in companies whose future is driven primarily by their own actions rather than relying on the largesse of the government.

During the quarter we sold some of holdings in the industrial and energy sectors and bought some well-priced stocks in the consumer and technology space. We realized profits from a biotechnology and an electrical equipment company that had reached our price targets. We trimmed our consulting industry investment for company specific reasons. The proceeds from these sales were invested in a combination of less cyclical companies (e.g., food, senior citizen housing, investor communication), inexpensive stocks (technology distribution, discount retail) and companies which offer growth at a reasonable price (medical products and mining equipment).

Large Cap Value
High Pointe's Large Cap Value strategy produced a return of 9.7%, which lagged its benchmark, the Russell 1000 Value Index by 0.8%. An overweighting of the energy sector and an underweighting of utilities added value during the quarter but it was offset by weak security selection in the technology sector.

A new government rule restricting the ability of debit card providers to charge market rate for their services adversely impacted our investment in the transaction processing business. Our view is that despite the new rule the oligopolistic nature of the industry will ensure high returns on capital. On the positive side, our energy sector holdings performed well as drilling activity increased.

We increased our investments in the financial and telecommunication sectors with proceeds from the consumer discretionary and consumer staples sectors. We took profits in an auto parts retailer and tobacco company that had reached our price targets. We also sold a cable company where performance had been uneven. The proceeds were spread over new investments in a multitude of industries with a primary focus on large cap blue chip stocks which in aggregate are selling at relative valuation levels not seen in many years.

Large Cap Growth
High Pointe's Large Cap Growth strategy produced a return of 11.3%, lagging its benchmark, the Russell 1000 Growth Index by 0.5% for the quarter. An overweighting of the health care sector and an underweighting of the materials sector detracted value but it was offset by strong stock selection in the health care and energy sectors.

In the health care sector, a bioscience tools company outperformed because of cost cutting and an improving outlook for research funding. In addition, a biotechnology company benefited from a drug prospects strong trial results. Also, our investments in the oil and gas industry performed well because of increasing drilling activity and rig orders.

During the quarter we increased our investments in the telecommunications and energy sectors and correspondingly reduced our allocation to the financial and consumer staples sectors. We realized profits from a data storage company that met our price target by gaining market share and improving margins. We sold an asset manager because its short-term investment performance deteriorated thus dampening its future business prospects. The proceeds were reinvested in the electronic measurement, computers and telecommunications industries.

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We wish you a Happy and Prosperous New Year, and thank you for the opportunity to manage your assets.