

HIGH POINTE

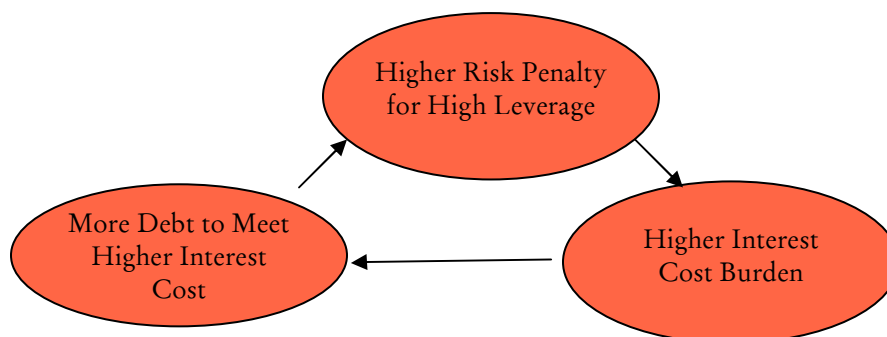
DATE: October 15, 2012
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

The Times They Are A-Changin'

*And the first one now,
Will later be last,
For the loser now,
Will be later to win,
For the times they are a-changin'.
-- Bob Dylan (1964)*

The stock market has rebounded, home prices are ticking up and employment is stable. On the surface, things seem to have returned to normal. The underlying reality is much different. These are not normal times. Much has changed since the start of the financial crisis five years ago. Some of the changes are profound and have significant implications for investors as we discuss below.

- Government bonds have become riskier but the governments have not paid a penalty for the **higher risk** - yet. It's a quagmire. Developed countries need either strong economic growth or sharp cost cutting to reduce their debt burden, but neither is in the offing. Higher debt typically leads to higher borrowing rates. Italy and Spain have already experienced the pain. Over time, the pain will likely spread to France, UK, and ultimately even Germany and U.S. When the market starts penalizing developed countries for their high leverage, it will likely lead to a vicious cycle as shown below.



- **Central banks have blatantly taken on the job of inflating asset prices.** By keeping interest rates near zero, central banks have encouraged investors to invest in higher risk assets such as “junk” bonds and emerging market debt. As a result, prices for these assets have risen. Investors should recognize this phenomenon. In the long run, investors will need to be careful about not overstaying in these assets.
- **Role of government bonds has changed from providing income and safety to just safety.** Some investors have started using high dividend stocks of utilities and telecom companies as substitute for bonds. We caution against this one-for-one substitution as a matter of principle because stocks do not carry a contractual guarantee of return of principal, and also because the valuations of utilities and telecom stocks are too high, in our opinion.
- **Investors have become more risk averse towards U.S. equities.** Investors have withdrawn \$300 billion out of U.S. equities since March 2009 when the market bottomed, according to mutual fund data compiled by Investment Company Institute. In doing so, investors have missed some of the spectacular gains in the stock market over the last 3-1/2 years.
- **Deleveraging is a secular theme.** Corporations and individuals are already going through it. At some point, governments will be forced to do the same. As a result, economic growth worldwide will be slow for a long time. This means investors will need to be selective about owning cyclical stocks whose fortunes are tied closely to economic growth. Such stocks are often found in the Energy, Raw Materials, Industrial and Consumer Discretionary sectors.
- **Gold has carved out a prominent place as a safe asset.** Given the amount of money printed by central banks, it is reasonable to assume that the value of paper currency relative to real assets will drop. It makes sense for investors to have some exposure to gold for safety and store of value. Other real assets may also preserve purchasing power in the long run but they do not provide short-term liquidity.
- **Corporations have become stronger, governments have become weaker.** Given all of the negative developments discussed above, the natural question is – what is an investor to do? The answer lies in looking at corporate America. Companies have strengthened their balance sheets and become more efficient. We like corporate America for the growth potential offered by its stocks and reasonable safety and income offered by its bonds, and we view them as core components of any investor’s portfolio.
- **For all the bad press they get (or perhaps because of it), bank stocks have become attractive.** It is true that banks’ profitability will never be the same as before because of regulation and banks still carry significant balance sheet risk. However, these negatives are offset by their historic low valuation relative to book value and their ability to buy back their own cheap stock to create solid earnings growth in all scenarios short of Armageddon.

There are good investment opportunities that have been created by the distortions caused by government interference and investor risk aversion. At High Pointe, we are finding them by taking a contrarian view (by overweighting banks), by focusing on valuation (by underweighting utilities and telecom stocks) and by focusing on balance sheet safety (by overweighting technology companies).

Investment Returns

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

Investment Performance (Net of Fees)¹ For Periods Ending September 30, 2012

	One Quarter	Year-to- Date	Five Years	Ten Years	Since Inception ²
Small Cap Equity	3.5%	14.8%	4.2%	13.4%	8.9%
Russell 2000 Index	5.3%	14.2%	2.2%	10.2%	5.9%
Large Cap Value	6.6%	14.8%	-0.4%	7.6%	8.5%
Russell 1000 Value Index	6.5%	15.8%	-0.9%	8.2%	5.3%
Large Cap Growth	6.3%	16.7%	2.7%	10.2%	7.5%
Russell 1000 Growth Index	6.1%	16.8%	3.3%	8.4%	1.1%
International Equity	8.4%	13.3%	-1.5%	N/A	0.3%
MSCI AC World ex US Index ³	7.4%	10.4%	-3.9%	N/A	-0.6%

¹Performance for the latest quarter is preliminary and subject to change.

²Inception Dates: Small Cap – January 1, 1998; Large Cap Value – January 1, 1998; Large Cap Growth – August 1, 1999; International Equity – December 31, 2006.

³Gross total return index from December 31, 2006 – December 31, 2009; Net total return index from January 1, 2010.

High Pointe Capital Management, LLC (the “Firm” or “High Pointe”) is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Advisers Acts of 1940 and its amendments. High Pointe is an independent investment management firm that is not affiliated with any parent organization.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Performance results are shown in U.S. dollars, 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 all accrued dividends and interest, realized and unrealized gains and losses. Gross dividends were used to calculate the performance prior to January 1, 2010. As of January 1, 2010, accrued dividends used are net of non-reclaimable withholding taxes. Leverage has not been used in the composite. High Pointe’s fee schedules are disclosed in Part 2A of the firm’s Form ADV. All fully discretionary, fee-paying accounts are included in at least one composite. 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.

The **Small Cap Equity** composite is comprised of portfolios invested primarily in stocks of companies with market capitalization of less than \$4 billion. The **Large Cap Value** composite is comprised of portfolios invested primarily in stocks of companies with market capitalization in excess of \$2 billion that offer good “value” relative to other companies in a similar business, their growth potential, or their historical valuation levels. The **Large Cap Growth** composite is comprised of portfolios invested primarily in growth stocks of companies with market capitalization in excess of \$1.5 billion that exhibit high expected earnings growth to maximize capital appreciation. The **International Equity** composite invests in stocks that are primarily domiciled in a country other than the U.S., including emerging markets, without any constraints regarding capitalization or style. A complete list of firm composites and performance results is available upon request. 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. Currently the index consisted of 44 countries (23 developed and 21 emerging countries). A net total return index reinvests dividends after the deduction of withholding taxes, using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treats. These indices do not reflect fees and expenses associated with the active management of separate account portfolios.

Investment Strategy

Small Cap Equity

High Pointe's Small Cap Equity strategy produced a return of 3.5% during the quarter, which trailed its benchmark, the Russell 2000 Index by 1.8%. During the quarter, stock selection in the consumer staples sector added value but was offset by weak stock selection in the technology and consumer discretionary sectors.

In the healthcare sector, the portfolio benefitted when a managed healthcare company agreed to be acquired at a significant premium. In addition, our investment in the gold mining industry outperformed as it was granted approval for a planned expansion. However, our investment in for-profit education struggled to bring costs in line with weak enrollment. In the technology sector, our overweight to the semiconductor industry detracted value.

During the quarter we increased our investments in the materials and consumer discretionary sectors and reduced our exposure to the technology and financial sectors. We realized profits as investments met our price targets in the heart healthy food, power tool, and retail industries and sold our investments in the brokerage and outsourced service industries because of their failure to meet our expectations. We reinvested the proceeds in chemicals, electronic equipment, consulting and veterinary service industries.

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 6.6%, which outperformed its benchmark, the Russell 1000 Value Index by 0.1%. Our portfolio benefitted from strong stock selection in the technology and healthcare sectors but was partially offset by weak security selection in the telecommunication sector.

In the healthcare sector, our investments in the pharmaceutical industry performed well because of strong sales and drug pipeline progression. In the technology sector, our security software industry investment benefitted from its increased focus on shareholder value. However, our logistics industry investment struggled along with the weak global economy.

During the quarter we sold an industrial machinery company that reached our price target because of an activist shareholder's involvement. We invested the proceeds in the insurance and communication services industries.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 6.3%, exceeding its benchmark, the Russell 1000 Growth Index by 0.2%. During the quarter, stock selection in the financial and material sectors added value but was partially offset by weak security selection in the technology sector.

In the technology sector, our holdings had disparity in performance. For instance, our consumer electronics and communication equipment industry investments outperformed because of strong demand for new products. In addition, our internet service company benefitted from solid growth as competition fears eased. However, our personal computer and semiconductor industry investments suffered as demand growth slowed considerably.

During the quarter we increased our investments in the healthcare and financial sectors and reduced our allocation to the energy and consumer discretionary sectors. We sold investments in media and watch industries that had performed well because of strong revenue growth and an oil and gas company that struggled in the face of low natural gas prices. We invested the proceeds in insurance brokers, healthcare services, pharmaceuticals, cable and logistics industries.

International Equity

High Pointe's International Equity strategy produced a return of 8.4%, outperforming the MSCI All Country World ex-US Index by 1.0% for the quarter.

Our European material sector holdings performed well because of strong demand and execution. In addition, our German application software industry investment outperformed as new products continued to generate growth opportunities. Our investments in industrial conglomerates benefitted from cost control.

During the quarter we increased our holdings in the financial and industrial sectors and reduced our investments in the consumer discretionary and material sectors. We also reduced our Japanese and U.K. investments in favor of European companies. Specifically, we repositioned our U.K. holdings out of television and publishing and into banks. We also sold Swiss and Irish industrial machinery holdings and invested the proceeds in Spanish and German construction companies. In addition, we increased our investments in the Netherlands' technical support and internet service industries.

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Thank you for your trust and confidence in High Pointe!