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DATE: July 23, 2013
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

The Naked Truth

It was April 2010. I was teaching a class in the MBA program at Northwestern University on the topic of hedge funds and other alternative assets. Our guest speaker was the head of a firm which collects and sells data on the performance of hedge funds. He proudly displayed a chart which showed that the average fund in each one of the 26 hedge fund categories had outperformed the S&P 500 Stock Index over the last ten years. However, there were two problems with that chart.

Before continuing on with the story, a definition of the term "hedge fund" is in order.

> *Hedge Fund: Historically, it meant an equity investment strategy that involved taking both long and short positions in stocks roughly in equal amounts such that the overall portfolio did not have significant "stock market risk". Nowadays, it means an investment vehicle that uses a variety of investment instruments, typically uses leverage, charges high fees including incentive fees, restricts capital withdrawals, and attempts to produce a return pattern that is less volatile than the broad equity market and has a low correlation with it.*

Now, let us go back to the story of the guest speaker. The two problems with that chart were as follows. One, the speaker had selected one of the worst time periods for the S&P 500 for comparison. Book-ended by the bursting of the internet bubble in 2000 and the financial crisis in 2008-2009, the S&P 500 had produced a return of -0.95% per year for ten years ending December 31, 2009, a lousy return indeed. However, the speaker failed to mention that such poor returns are rare for the S&P 500 Index. Indeed, over the long term (since 1926) the S&P 500 Index has performed better than this anemic threshold more than 96% of the time.

The second issue with the hedge fund performance chart was that the speaker did not acknowledge that hedge fund performance databases suffer from some serious biases that cause the reported performance to be higher than true performance. One of my sharper students who had read the assigned materials asked "what do you think of the paper by Ibbotson and Chen[1] which shows that a significant portion of the apparent value added by hedge funds is negated when you adjust for biases in the hedge fund databases?" To my surprise, the speaker pleaded ignorance of the research.

[1] "The A,B,Cs of Hedge Funds: Alphas, Betas, and Cost", Yale ICF Working Paper No. 06-10, September 2006, by Roger Ibbotson and Peng Chen (Subsequently updated and published in Financial Analysts Journal, January/February 2011)

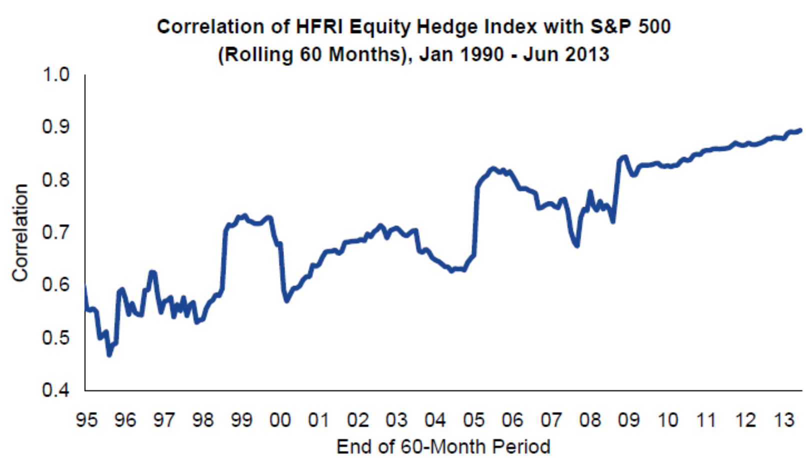
The research paper referred to by my student discusses two particular biases in hedge fund datasets. One is survivorship bias whereby databases consist primarily of funds that were successful because unsuccessful funds routinely drop out of the databases. The second bias, called the backfill bias, refers to the tendency of funds to wait until they had a successful performance record and then backfill the database with these high returns.

The researchers showed that before adjusting for these two biases, the reported return for the average hedge fund was 14.9% per year. Adjusting for survivorship bias decreased the return to 11.7% and adjusting for backfill bias reduced it further to 7.7%.

Interestingly, despite this significant drop in value added resulting from correction of data collection biases, the authors found that hedge funds had still added some value. However, the authors had not adjusted for all possible biases. In particular, one bias that remained was self selection bias whereby some hedge funds never report their returns. A more recent paper[2] tackles this problem. The authors find that indeed true hedge funds returns are lower than those estimated by industry databases because weak performers never report their results.

Quite frequently, people ask for my opinion of hedge funds because they have heard how hedge funds do well even when the stock market is doing poorly. This statement is true almost by definition rather than because of hedge fund managers' skills. The reason is that equity-oriented hedge funds typically take short positions with a portion of their assets. Therefore, it is logical that they should do better than long-only equity mutual funds when the market goes down.

It is hard for me to be enthusiastic about hedge funds, in general, for most individual investors because there is not enough evidence for my satisfaction that they have added value. The only thing certain about the average hedge fund is that it costs a lot. The research cited earlier showed that the all-in cost of hedge funds is over 3% per year. Moreover, hedge funds have become more positively correlated with the S&P 500 Index as show in the graph below[3], thus reducing the diversification benefit that used to be a key desirable characteristic of them.



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[2] "Out of the dark: Hedge fund reporting biases and commercial databases" by Aiken, Clifford and Ellis, July 2012, http://ssrn.com/abstract=1519914

[3] "U.S. Equity Strategy", a Morgan Stanley Publication, July 10, 2013

These considerations have caused High Pointe to shy away from typical hedge fund practices such as the use of leverage, derivatives, high fees, and withdrawal restrictions. We firmly believe that our clients will come out ahead in the long run because of these standards of practice.

The hedge fund industry has been an emperor of the investing world attracting much adulation, especially in the period immediately following the great financial crisis. The truth of the matter is that this emperor has no clothes. Investors must critically examine the hedge fund choices put in front of them to make sure they won't lose their shirt to the emperor.

Groucho Marx once said that he did not want to be member of a club that would admit people like him as members. That is how I feel about most individual investors wanting to join the club of hedge fund investors. Obviously, there are some hedge funds out there that are good, but chances are high that if a hedge fund is looking for you to be an investor, it is likely not worthy of your money.

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 June 30, 2013

	One Quarter	One Year	Five Years	Since Inception[2]
Small Cap Equity	3.0%	19.7%	11.6%	9.4%
Russell 2000 Index	3.1%	24.2%	8.8%	6.7%
Large Cap Value	5.7%	25.1%	8.0%	9.2%
Russell 1000 Value Index	3.2%	25.3%	6.7%	6.1%
Large Cap Growth	1.1%	16.6%	7.6%	7.7%
Russell 1000 Growth Index	2.1%	17.1%	7.5%	1.8%
International Equity	-1.1%	15.9%	2.7%	1.3%
MSCI AC World ex US Index[3]	-3.1%	13.6%	-0.7%	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.
[3]Gross total return index from December 31, 2006 – December 31, 2009; Net total return index from January 1, 2010.

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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. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group. 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 3.0% during the quarter compared to 3.1% for its benchmark the Russell 2000 Index. During the quarter, stock selection in the financial and technology sectors added value and security selection in the materials sector detracted from it.

In the technology sector, our investments in the software industry benefitted from strong growth as well as sharper management focus. In addition, our investment in the investment management industry continued to gain assets because of its strong performance record. In the consumer discretionary sector, our investments in the retail industry performed well as their outlook improved. However, our investments in the forest product and 3-D measurement industries were negatively impacted by the weak macro environment.

During the quarter we increased our investments in the consumer discretionary and energy sectors and reduced our allocation to the industrial and healthcare sectors. We realized profits from a financial adviser that was acquired at a significant premium and a healthcare instrument and service company that had executed well. We invested the proceeds in leisure and health product industries. We also repositioned our financial sector investments in the asset management, brokerage and insurance industries.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 1.1% compared to 2.1% for the benchmark, the Russell 1000 Growth Index. During the quarter, stock selection in the consumer discretionary and industrial sectors detracted value but was partially offset by strong stock selection in the technology sector.

In the communications equipment and computer hardware industries, our holdings were negatively impacted by weak demand and concerns about sustainability of high profitability. In the material sector, our mining industry holding faced the headwinds of declining copper and gold prices. On the positive side, our investments in the internet and software industry performed well from the combination of strong growth and profit generation.

During the quarter we increased our exposure to the healthcare and consumer staples sectors and reduced our investments in the consumer discretionary and technology sectors. We trimmed our holdings in the communications equipment and computer hardware industry in favor of global positioning and glass display companies. In addition, we repositioned our energy investments into companies with more monopolistic positioning and natural gas exposure.

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 5.7%, exceeding its benchmark, the Russell 1000 Value Index by 2.5%. Security selection was strong during the quarter with the financial, consumer discretionary and industrial sectors adding the most value.

In the financial sector, our investments in the life insurance, banking and brokerage industries benefitted from higher long-term interest rates and profitability expectations. In the communications equipment industry, our investment continued to gain market share and expanded its product lines. Our defense industry investment executed well and returned cash to shareholders.

We increased our investments in the consumer discretionary and financial sectors with proceeds from the industrial and technology sectors. Specifically, we reduced our software and computer storage industry investments that performed well recently because of strong growth. The proceeds were reinvested in the cruise line and auto parts industries. We also repositioned our energy sector investments in the oil and gas equipment and exploration industries.

International Equity
High Pointe's International Equity strategy produced a return of -1.1% outperforming its benchmark, the MSCI All Country World ex-US Index, which produced a return of -3.1% for the quarter.

Our Japanese brokerage industry holding continued to benefit from a strong market environment. In addition, our investments in United Kingdom and European banking and insurance industries performed well as long-term interest rates increased and growth forecasts improved. In the telecommunication sector, our Japanese holding executed well with strong growth in both its mobile and fixed line segments.

During the quarter we increased our holdings in the industrial sector and reduced our investments in the consumer discretionary and financial sectors. We also decreased our emerging market investments opting instead for United Kingdom and Japanese companies. Specifically, we sold investments in emerging market banks. We invested the proceeds in the diversified banking, logistics and heavy equipment industries in Western Europe. In addition, we repositioned our telecommunication sector investments out of New Zealand and into Japan.

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We are obviously pleased with the fact that equity markets have produced high absolute returns over the past year and that we have participated nicely in this upsurge. At the same time, we are keenly aware of the fact that high returns lead to fuller stock market valuations. We are repositioning our portfolios modestly by selling some securities that have reached full valuations and replacing them with other high quality names that remained undervalued.

Thank you for your trust and confidence. We look forward to reporting our third quarter results to you in October. In the meantime, please call us with any questions or comments.