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High Pointe

DATE: April 22, 2014
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

The Fast and the Furious

I met Michael Lewis in October 2005, shortly after the publication of his book *Moneyball*. He laughed when I told him that my 10-year old son, Brian, had just learned his first four-letter words from reading his book. He proceeded to tell me that the hero of his book, Billy Beane, General Manager of Oakland A's, called to scold him when *Moneyball* was published. Billy was concerned that his mother would read the book and discover that her son uses four letter words!

Lewis' books, starting from *Liar's Poker* in 1989 to the #1 bestseller *The Big Short*, have always commanded attention. However, his latest book, *Flash Boys*, has generated the most controversy, questions, and actions. This book discusses the world of "High Frequency Trading" where traders trade fast and furious using cutting edge technology to generate vast amounts of profits at the expense of those with conventional, slower technology.

The book's most controversial statements relate to its claim that the stock market is rigged. Such claims might lead one to believe that small, individual investors have no chance against unscrupulous brokers and fast traders. Before getting discouraged let us try to understand the magnitude of the problem for individual investors. It may cost an average individual investor a few pennies per share extra to buy a stock if he is being taken advantage by High Frequency Traders. Is this situation much different than going to buy a new car, where the salesman's goal is to get the highest possible price from the buyer? The car buyer does not run away from the problem of buying the car just because someone on the other side is trying to maximize his profit. Instead, a smart buyer becomes knowledgeable before engaging in the purchase transaction. Well, the same can be true for buying stocks.

To become an informed, knowledgeable buyer in the investment business is not easy because we are never educated or trained for this job. Nevertheless, here are a few pointers that might help you.

When it comes to trading, an investor is better off if he trades infrequently (i.e., has low turnover) and is patient and focused on valuation (i.e., steps back from the trade if the market moves "away" from his desired purchase price). Remember, being a small investor can be an advantage in the equity market because one can execute a trade without adversely impacting the stock price, a luxury denied the largest traders. It is also worth noting that that the cost of trading in the equity market are very low and much lower than they used to be a few years ago.

Amidst all the hoopla surrounding the advantage gained by High Frequency Traders, individual investors seem to be overlooking some more important questions. In particular, the following two questions should be high priorities for any individual investor.

- What is the cost of buying bonds and is the bond market rigged?
- Does my investment adviser accept fiduciary responsibility?

Cost of Buying Bonds

For most individual investors, the cost of buying bonds is hidden. An individual investor never sees a line item on his account statement that shows how much money his broker made on the trade. It is just inherent in the price of the bond. Here is how it works. If the investor wants to buy a bond, the broker will quote him a price, say $103¼ but if an investor wants to sell the same bond, the broker will quote a different price, say, $102¾. The difference between the two quotes, 50 cents, reflects trading costs but this information is not usually shared with the investor.

To make matters worse, small, individual investors are usually quoted prices that are less attractive than those that are quoted to large, institutional investors. Within the last few weeks, the SEC has finally started asking questions about whether small investors get worse price quotes than large investors.

So, in the bond market it is a disadvantage to be a small investor whereas in the stock market it can be advantage. Unless the SEC investigation leads to a change in practice for how individual bonds are sold to small investors, it is my opinion that for most individual investors, buying superior, low cost bond mutual funds is a better option than buying individual bonds because it allows them to piggy back on institutional investors.

Fiduciary Responsibility

The second important issue raised above relates to acceptance of fiduciary responsibility. Most individual investors do not know why this question is even relevant. The answer is that only the fiduciary standard requires that the investment adviser act in the client's best interest. Brokers and the advisers employed by them are typically not bound by the fiduciary standard regardless of whether they work for Morgan Stanley, UBS, Citicorp, Merrill Lynch, Goldman Sachs, Smith Barney, or any of the other brokerage firms. The SEC has tried in vain to apply the fiduciary standard to broker-advisers but it has been stymied by the brokers' powerful lobby.

We remind you of an educational piece that empowers individual investors by providing them with a checklist of twenty questions, such as the one regarding fiduciary responsibility standard. This checklist can help an investor distinguish between a good and not so good investment adviser. It is available via the following link.

http://www.highpointecapital.com/docs/AdviserEvaluationChecklist.pdf

What's Next

Let's get back to Michael Lewis' book. It has generated heated arguments on both sides – those that defend High Frequency Trading and those that think it is evil. Regardless, I believe this debate will have a beneficial impact. It will likely make stock exchanges re-examine their practices to make sure their data are accessible to all market participants on a fair and equitable basis. More importantly, it will cause brokers to change some egregious practices that run counter to their clients' (i.e., investors') interests.

We, at High Pointe, practice what we preach. In the portfolios we manage for our clients, we keep turnover low, trade patiently, accept fiduciary responsibility and, lastly, we buy individual stocks, but not individual bonds. High Frequency Traders might win via fast and furious trading, but for most individual investors, patient and methodical investing is the winning way.

Investment Returns

Three of High Pointe's four products outperformed their respective benchmarks, net of fees, in the first quarter of 2014. Our returns are summarized below and a discussion of our investment strategy follows in the next section.

Investment Performance (Net of Fees)[1]

For Periods Ending March 31, 2014

	One Quarter	One Year	Five Years	Since Inception[2]
Small Cap Equity	0.3%	23.1%	24.1%	10.2%
Russell 2000 Index	1.1%	24.9%	24.3%	7.7%
Large Cap Growth	2.0%	22.4%	20.4%	8.7%
Russell 1000 Growth Index	1.1%	23.2%	21.7%	3.0%
Large Cap Value	4.5%	28.3%	20.2%	10.1%
Russell 1000 Value Index	3.0%	21.6%	21.7%	6.9%
International Equity	2.2%	19.6%	17.6%	3.8%
MSCI AC World ex US Index[3]	0.5%	12.3%	15.6%	2.4%

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

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 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 **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 **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 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 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 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 0.3% during the quarter, lagging its benchmark, the Russell 2000 Index by 0.8%. During the quarter, stock selection in the industrial and energy sectors detracted value but was partially offset by strong stock selection in the materials and consumer discretionary sectors.

In the industrial sector, our holdings struggled in the face of anemic economic growth. In the healthcare sector, our biotechnology industry investment suffered as it was unable to file for accelerated approval for a promising drug. On the positive side, our health care technology investment performed well as new management improved execution. In addition, our investment in the auto industry continued to benefit from the adoption of heated seats in mid-priced cars.

During the quarter we increased our investments in the technology and financial sectors and reduced our allocation to the industrial and consumer discretionary sectors. We sold an industrial equipment company that had performed well and a health care service company that had struggled with regulatory headwinds. The proceeds were reinvested in the mortgage insurance industry. We also repositioned our technology sector investments out of rental housing software and into semiconductors.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 2.0% exceeding its benchmark, the Russell 1000 Growth Index, by 0.9%. During the quarter, security selection was strong in the healthcare sector but was partially offset by weak stock selection in the materials sector.

In the healthcare sector, our portfolio benefitted when a pharmaceutical holding agreed to be acquired at a significant premium. In the technology sector, our investment in the software industry performed well as new management expanded product offerings and increased the focus on "cloud" initiatives. In addition, our investment in railroads executed well as cargo volumes improved. On the other hand, our investment in the machinery industry struggled with weak demand and acquisition integration issues.

We did not make any changes to the portfolio during the quarter. Due to market fluctuations our weight in the healthcare sector increased and our investment to the consumer discretionary sector decreased.

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 4.5%, outperforming its benchmark, the Russell 1000 Value Index by 1.5%. Security selection was strong during the quarter, with holdings in the healthcare and energy sectors adding the most value.

In the healthcare sector, our investments in the pharmaceutical industry performed well because of drug pipeline progression and a favorable acquisition. In addition, our investment in the cruise line industry benefitted from strong execution and market share gains. However, our auto industry holding suffered because of negative headlines from a recall.

We did not make any changes to the portfolio during the quarter. We remain overweighted in healthcare and technology sectors and underweighted in industrials, consumer staples and utilities.

International Equity

High Pointe's International Equity strategy produced a return of 2.2% compared to 0.5% for its benchmark, the MSCI All Country World ex-US Index.

Our Italian banking industry holding performed well because of higher profit expectations and restructuring efforts. Our Australian life insurance investment benefitted as its wealth management segment improved with capital markets. In the mining industry, our United Kingdom investment executed well generating higher revenue. However, our investment in the United Kingdom defense industry struggled because of weak sales guidance.

During the quarter, we increased our holdings in the consumer discretionary and telecommunication sectors and reduced our investments in the energy sector. We repositioned our Japanese investments from motorcycle manufacturing to advertising. We also reallocated our United Kingdom holdings out of food retail and into packaged foods. In addition, we sold a Russian oil and gas company in favor of a Mexican broadcasting company.

As emerging markets continue to underperform it gives us the opportunity to buy selectively. As a result our underweighting to emerging markets is slowly dissipating.

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Thank you for the opportunity to manage your assets! We are pleased with the start to 2014 and look forward to reporting our second quarter results to you in July.