

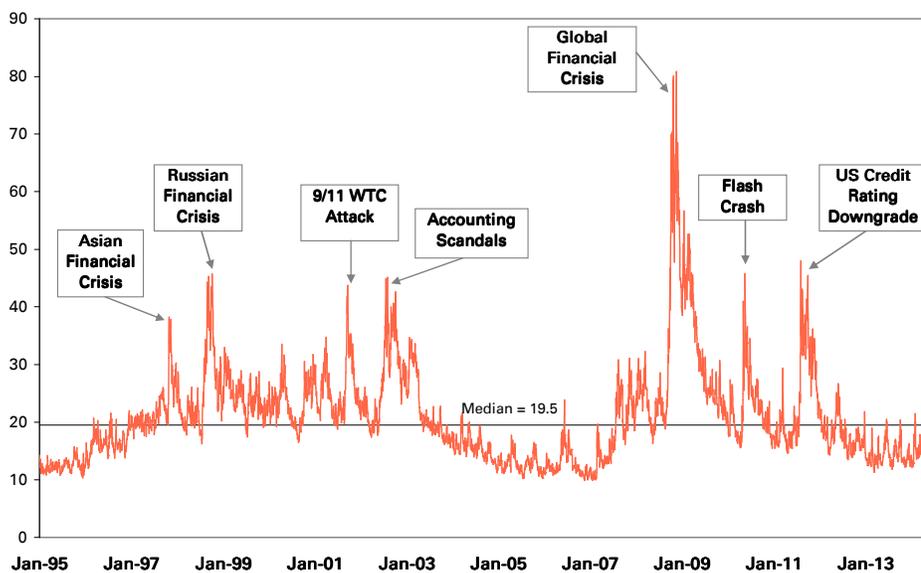
HIGH POINTE

DATE: July 14, 2014
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Fear and Rationality

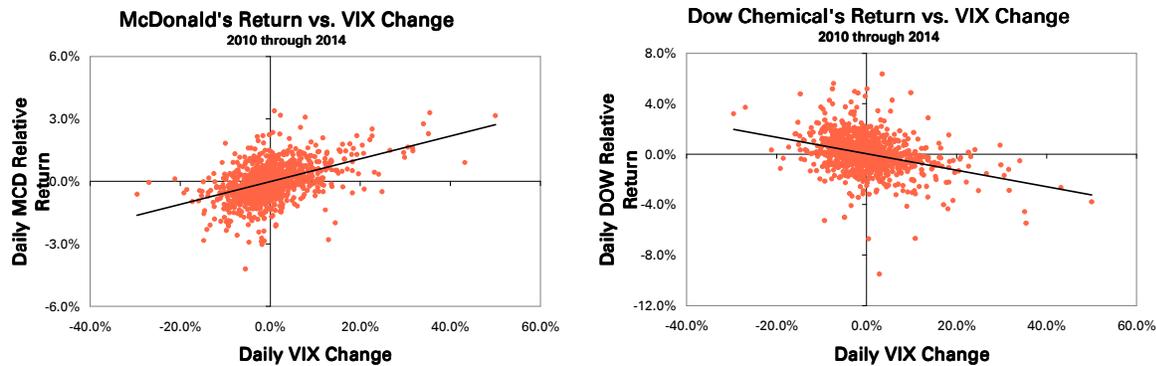
“Be fearful when others are greedy and greedy when others are fearful” is one of Warren Buffett’s many quotable quotes. Wouldn’t it be nice if one could easily tell when others are being fearful or greedy? As it turns out, one can. There is an index called VIX that gives a precise measure of the level of fear amongst investors. VIX refers to the implied volatility in the S&P 500 Stock Index options. It is a highly reliable measure of investors’ sentiment. Colloquially, it is sometimes called the Fear Index and it definitely spikes up when investors get nervous as shown in the graph below.

VIX - The Fear Index



Let’s now take this one step further. Can one figure out how different stocks react to changes in the fear index? Absolutely. In fact, we at High Pointe have done so for several years now for virtually all stocks in the United States. A sample of our work is shown on the next page using McDonald’s and Dow Chemical as examples. Both are large, blue chip companies that have been

around a long, long time. But, their stocks behave very differently in response to changes in fear level as shown below.



It is easy to see that when fear increases McDonald's performs relatively well and Dow Chemical performs relatively poorly. The reverse is true when fear decreases. This analysis is one example of how we apply a unique, data-driven approach to understand the true characteristics of each stock instead of relying on intuition and heuristics. Such objective investing is critical because it is increasingly evident that the human brain has a tendency to rely too much on short cuts inherent in heuristics, or rules of thumb, and in doing so it is prone to making errors.

In a book entitled *Thinking Fast and Slow*, Nobel-prize-winning research psychologist Daniel Kahneman describes in detail the fallibility of the human brain. I first came across Kahneman's work in 1985 while searching for a suitable topic for my dissertation. His research had shown how human beings are not always rational in making their decisions. Some of the irrationality is derived from our biases and our brain's tendency to take short cuts. I realized his research would have strong applicability to the stock market and that understanding other investors' biases could help one become a better investor.

Ever since then I have kept track of his work as he has been joined by many others to develop a field of study called Behavioral Finance. Some of the key observations by researchers in this field that have applicability to stock market investors are as follows.

- People are overconfident in their decision making, overconfidence leads to excessive trading, and investors who trade excessively generate lower returns
- Investors are loathe to sell securities that have gone down in price
- Investors are overly influenced by recent events
- Investors associate familiarity with low risk
- Investors under-react to a single piece of corporate news such as earnings but overreact to a series of consistent announcements

By being aware of potential investing biases and by extensively using data to make our decisions, we at High Pointe strive to take emotions out of investing and instead make our decisions based on rationality and evidence.

Investment Returns

Three of High Pointe's four products outperformed their respective benchmarks, net of fees, in the second 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 June 30, 2014

	One Quarter	One Year	Three Years	Since Inception ²
Small Cap Equity	2.9%	23.0%	14.2%	10.2%
Russell 2000 Index	2.1%	23.6%	14.6%	7.7%
Large Cap Growth	5.2%	27.3%	17.1%	9.0%
Russell 1000 Growth Index	5.1%	26.9%	16.2%	3.3%
Large Cap Value	6.5%	29.3%	17.3%	10.3%
Russell 1000 Value Index	5.1%	23.8%	16.9%	7.1%
International Equity	3.9%	25.6%	9.3%	4.2%
MSCI AC World ex US Index ³	5.0%	21.8%	5.7%	3.0%

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

²Inception Dates: Small Cap – January 1, 1998; Large Cap Growth – August 1, 1999; Large Cap Value – January 1, 1998; 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 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 45 countries (22 developed and 23 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 2.9% during the quarter, outperforming its benchmark, the Russell 2000 Index by 0.8%. During the quarter, stock selection was strong in the industrial and consumer discretionary sectors.

In the industrial sector, our investment in the electrical components industry performed well because of increasing acceptance of its products for hybrid and electric cars. In the consumer discretionary sector, our auto industry investment continued to benefit from the adoption of heated and climate controlled seats. In addition, our discount retail investment benefitted as management made progress on turnaround efforts. On the other hand, our investment in the health food industry struggled with higher costs and competition.

During the quarter we increased our investments in the consumer discretionary and industrial sectors and correspondingly decreased our investments in the material, financial and healthcare sectors. We sold a chemicals company that had benefitted from a strong environment and a biotechnology company that had disappointing drug trial results. The proceeds were reinvested in the machinery and consulting industries. We also repositioned our consumer discretionary sector investments out of home furnishings industry and into apparel industry.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 5.2% compared to 5.1% for its benchmark, the Russell 1000 Growth Index. During the quarter, an underweight to the consumer discretionary sector and an overweight to the energy sector added value but was partially offset by weak stock selection in the healthcare sector.

In the computer hardware industry, our holding performed well because of improved sales execution and higher profitability. Our investments in the energy services industry benefitted from a strong environment for energy exploration in North America. In addition, a new investment in automotive retail resumed its healthy growth rate after a couple of lackluster quarters. However, our investment in the engineering and construction industry struggled with integrating a recent acquisition.

During the quarter we increased our investments in the consumer discretionary and technology sectors and reduced our investments in the healthcare and consumer staples sectors. We sold a pharmaceutical company that agreed to be acquired at a significant premium and a household product company that had performed well. In addition, we reduced our industrial sector investments that had struggled with weak execution. The proceeds were reinvested in retail, asset management, computer storage and energy services industries.

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 6.5%, exceeding its benchmark, the Russell 1000 Value Index by 1.4%. During the quarter, security selection was strong, especially in the technology and energy sectors.

In the technology sector, our investments in the semiconductor industry benefitted from lower than expected supply as competitors acted more rationally and demand for computers improved.

Our investment in the energy services industry performed well based on its ability to continuously maintain its technological edge and introduce new, more efficient products. In addition, our exploration and production investments executed well.

During the quarter, we decreased our investments in the healthcare and consumer discretionary sectors and increased our investments in the industrial and financial sectors. In the pharmaceutical industry, we sold companies that had performed well because of drug pipeline progression and an acquisition at a significant premium. We also took profits in our cruise line industry investment which gained market share as its competitor faced negative headlines. We invested the proceeds in the machinery, apparel and real estate service industries.

International Equity

High Pointe's International Equity strategy produced a return of 3.9% lagging its benchmark, the MSCI All Country World ex-US Index, by 1.1%. During the quarter, stock selection in the consumer discretionary sector added value but was more than offset by weak stock selection in the material and financial sectors.

Our Swiss and French banking industry holding underperformed because of the continuing fall out of banking industry participants' negotiations with U.S. regulators over fines related to business practices. In the communications equipment industry, our investment struggled with a weak environment. On the positive side, our Canadian oil and gas exploration and rail industry investments performed well with strong execution and higher demand. Our investment in the Indian stock market paid off as a more business friendly government won the national election in a landslide.

During the quarter, we increased our holdings in the consumer staples and industrial sectors and decreased our investments in the financial and healthcare sectors. We also repositioned investments from North America and continental Europe, into the United Kingdom. Specifically, we sold banking industry investments in Brazil and Italy that had performed well and invested the proceeds in a U.K.-based global leader in the distillery industry. In addition, we repositioned our industrial sector holdings out of machinery and into building products and electrical components.

* * * * *

Thank you for the opportunity to manage your assets! We are pleased with our absolute and relative returns in 2014 and look forward to reporting our third quarter results to you in October.