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High Pointe

DATE: January 20, 2015
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Oil Spill

Undoubtedly, the biggest economic story of the last six months is the spectacular decline in oil prices. Oil prices are down more than 50% in this short period. Traditionally, low oil prices have been considered favorable for economic growth. But this time, instead of being viewed as a "catalyst" for economic growth, they are being viewed as a "symptom" of weak economic growth.

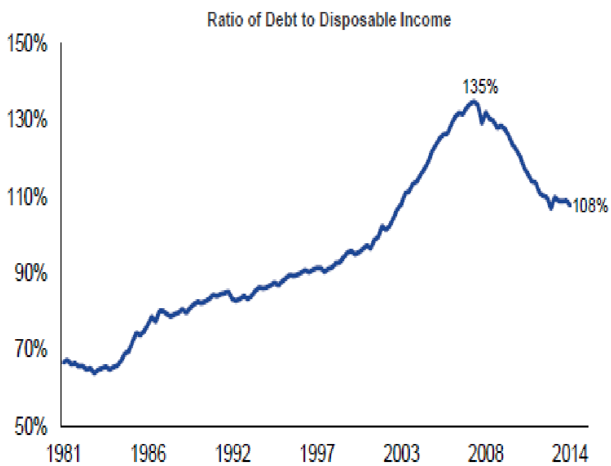
A decline in oil prices has cast a pall on global capital markets and headlines in the financial press have turned decisively more negative. There are frequent mentions of recessionary signs in Europe, slowdown in China, Greece's potential exit from the Euro, etc. These perceived and real problems have led to a higher aversion to risk as measured by an increase in the Volatility Index, VIX.

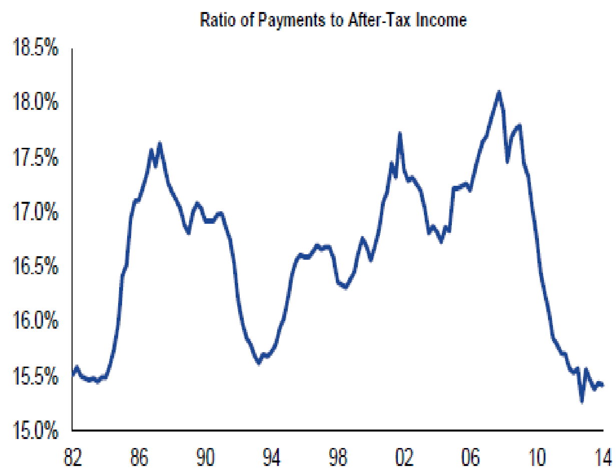
Not surprisingly, in this environment of increasing risk aversion, cyclical stocks, such as energy, mining, industrials and technology sectors have taken it on the chin. By contrast, noncyclical stocks, such as utilities, consumer staples and healthcare have held up well. We illustrated this phenomenon in our last quarter's client letter, and it has only been accentuated since then.

Other things being equal, we are attracted by the lower valuation of cyclical stocks and we have made some incremental purchases as their prices have come down. However, we want to have some sense of "downside protection" before placing a bigger emphasis on them. Downside protection can come from a strong balance sheet. Since the U.S. economy is primarily a consumer-led economy, we start with a look at the consumer balance sheet with the help of the two graphs shown on the next page.

The first chart shows the ratio of debt-to-disposable-income for individuals. It shows that the ratio peaked at 135% at the time of the housing bubble led financial crisis. It has been steadily declining since then all the way to pre-housing bubble levels. The second chart shows the proportion of a household's income that goes towards making interest payments. This ratio also peaked during the housing bubble and has declined dramatically to levels not seen since 1982.

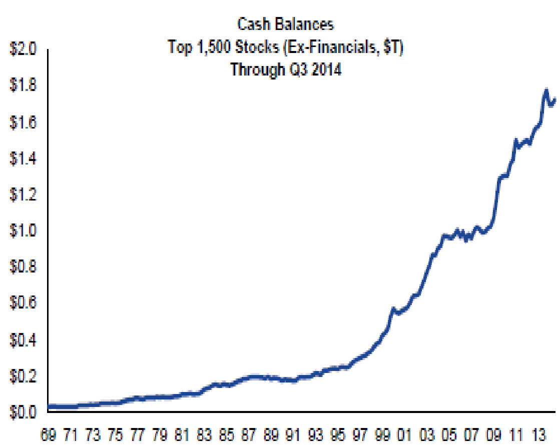
The reason for the sharper decline in this second chart is that in addition to showing the impact of de-leveraging, it also includes the tailwind provided by declining interest rates.

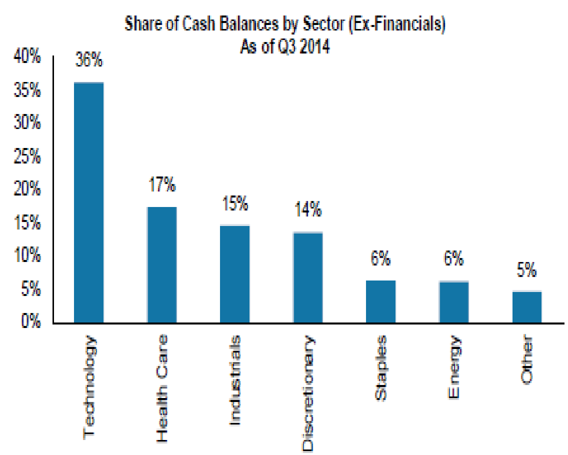




Source: U.S. Equity Strategy, a Morgan Stanley Publication by Adam Parker, December 5, 2014

As individuals have repaired their balance sheets, so have corporations. The left hand side chart below shows the dramatic increase in cash balances held by corporations. The right hand side chart shows the sectors of the stock market which hold the most cash. Interesting, two cyclical sectors, Technology and Industrials, hold more than 50% of the cash.





Source: U.S. Equity Strategy, a Morgan Stanley Publication by Adam Parker, December 5, 2014

As we all know, our central banks have taken on extraordinary levels of debt even as individuals and corporations have reduced their debt burden. Central banks' actions have put us in an unchartered territory with significant risks to stocks and all other risky assets if the bankers lose their credibility. Having said that, it is clear from the data above that at least at the individual and corporate level, the system is stronger than it was just prior to the financial crisis. This strength should provide some downside protection and be the basis for owning common stocks for the long run, including cyclical stocks with strong balance sheets that are supported by attractive valuation levels.

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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 December 31, 2014

	One Quarter	One Year	Three Years	Since Inception[2]
Large Cap Value	4.3%	16.5%	22.2%	10.3%
Russell 1000 Value Index	5.0%	13.5%	20.9%	7.2%
Large Cap Growth	5.0%	13.7%	20.0%	9.1%
Russell 1000 Growth Index	4.8%	13.1%	20.2%	3.6%
Small Cap Equity	8.9%	2.4%	17.4%	9.8%
Russell 2000 Index	9.7%	4.9%	19.2%	7.5%
International Equity	-3.5%	-2.0%	12.0%	2.9%
MSCI AC World ex US Index[3]	-3.9%	-3.9%	9.0%	1.6%

[1]Performance for the latest quarter is preliminary and subject to change.
[2]Inception Dates: Large Cap Value – January 1, 1998; Large Cap Growth – August 1, 1999; Small Cap - 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 any portfolio 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 **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 **Small Cap Equity** composite is comprised of portfolios invested primarily in stocks of companies with market capitalization of less than $4 billion. 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 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 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. 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

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 4.3% for the quarter, trailing its benchmark, the Russell 1000 Value Index by 0.7% for the quarter, but outperforming it by 3.0% for the year. During the year, security selection was strong in the healthcare and technology sectors, but was partially offset by weak stock selection in the financial sector. Our sector selection also added value with an overweight to the technology sector and an underweight to the industrial sector.

During the year, our investment in the pharmaceutical industry performed well because of a favorable acquisition. In addition, our investment in the managed care industry benefitted from good execution and cost control. In the technology sector, our investments in the semiconductor industry performed well with strong growth, profitability and a favorable environment. In addition, our communication equipment industry investment benefitted as new products generated growth. Our investment in the technology hardware industry also performed well as new management continued to focus on ways to unlock shareholder value.

During the quarter, we decreased our investments in the industrial sector modestly and increased our investments in the healthcare sector. In the industrial machinery industry, we sold a company that struggled in a weak environment. We invested the proceeds in oil and gas exploration as prices declined, and the managed healthcare industry.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 5.0% during the quarter, exceeding its benchmark, the Russell 1000 Growth Index by 0.2% for the quarter, and by 0.6% for the year. During the year, strong stock selection in industrials added value, but was partially offset by weak security selection in technology. Our sector selection also added value as we were overweight in the healthcare sector and underweight in the consumer discretionary sector.

During the year, the portfolio benefitted from an acquisition in the pharmaceutical industry. In addition, our investment in the computer hardware industry also performed well with as new products generated strong sales. In the industrial sector, our airline industry holding benefitted from lower oil prices and strong cost management. On the other hand, our investment in the construction and engineering industry struggled in the face of lower oil prices and an investment in semiconductor industry suffered from a slow adoption of LED products.

During the quarter we increased our investments in the healthcare and consumer discretionary sectors and decreased our investments in the technology sector. We sold the LED semiconductor company and a communication equipment company that had performed well but lacked further upside visibility. We reinvested the proceeds in the casino, apparel retail and drilling industries. In the industrial sector we sold a logistics company that benefitted from the growth in e-commerce and invested in the electrical components industry. Lastly, we reallocated our healthcare sector holdings from the medical equipment industry and into biotechnology.

Small Cap Equity

High Pointe's Small Cap Equity strategy produced a return of 8.9% during the quarter, lagging its benchmark, the Russell 2000 Index by 0.8% for the quarter, and by 2.5% for the year. During the year, stock selection was weak in the healthcare and energy sectors, but was partially offset by strong security selection in the consumer discretionary sector.

During the year, our investment in the auto parts industry performed well as demand was strong for its heated and climate controlled seats. In addition, our investment in the healthcare equipment industry benefitted from an increase in the adoption of its home dialysis system. On the other hand, our investment in the electrical components industry struggled as its largest customer experienced disappointing sales. In the energy sector, our investment in renewable oils suffered from production delays and a weaker economic environment.

During the quarter we increased our investments in the technology and healthcare sectors and reduced our investments in the material and consumer discretionary sectors. In the materials sector, we eliminated our investment in the precious metal industry. In the consumer discretionary sector, we sold a tire manufacturer that had benefitted from good sales volume and an apparel retailer that had failed to meet expectations. We invested the proceeds in home improvement retail, movies and oil and gas exploration. In addition, we repositioned our technology investments out of electronic components and into internet software and services. We also repositioned our investments in the healthcare equipment and technology industries

International Equity
High Pointe's International Equity strategy produced a return of -3.5% during the quarter, outperforming its benchmark, the MSCI All Country World ex-US Index, by 0.4% for the quarter, and by 1.9% for the year. During the year, stock selection in the materials and consumer discretionary sectors added value but was partially offset by weak security selection in the industrial sector. In addition, our underweight in the energy sector also added value.

During the year, our European brewery industry holding performed well with strong sales even as it rebuffed a competitor's takeover offer. In the financial sector, our Indian stock market investment benefitted from a business friendly government. Our Taiwan holding executed well as demand for its smartphone semiconductors was strong. Our Canadian railroad investment performed well with a favorable industry environment. In the consumer discretionary sector, our Indian automobile industry holding profited from robust demand for its luxury car models.

During the quarter, we increased our holdings in the consumer discretionary and energy sectors and decreased our investments in the consumer staples and financial sectors. We also repositioned some investments out of the Pacific-Basin and Japan and into continental Europe and the UK. Specifically, we sold Australian and German asset management companies and European brewery and distilleries that had performed well. We reinvested the proceeds in the European drilling and oil and gas service industries as prices declined. In addition, we repositioned our consumer discretionary holdings out of the Japanese automobile industry and into UK cable, German apparel and Hong Kong casino companies.

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Thank you, as always, for asking us to shepherd your investments. We are taking a long-term view of corporate investments based on the type of data shared with you in this letter.