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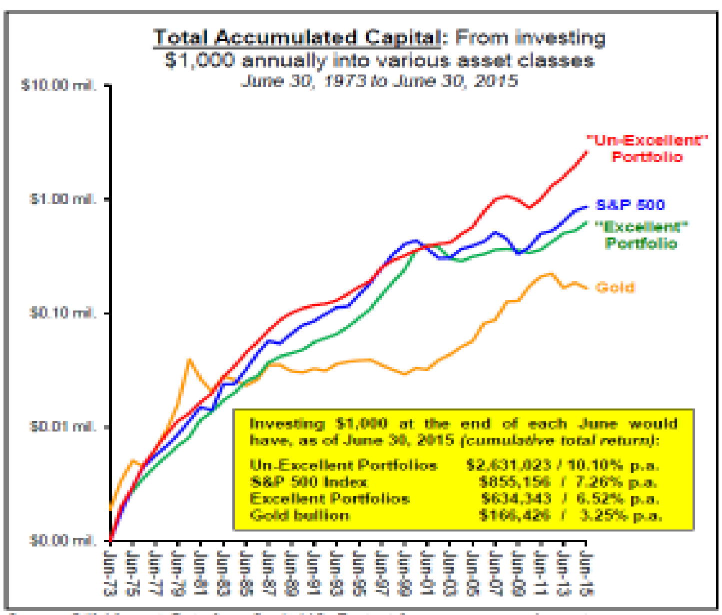
High Pointe

DATE: July 14, 2015
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

In Search of Excellence

One of the bestselling business books ever was published in 1982. Written by Thomas Peters and Robert Waterman, Jr., the book is entitled *In Search of Excellence*.

The authors of the book studied "excellent" companies in the United States to learn what made them tick. To select excellent companies, they used several techniques including historical financial performance criteria. Recently, Barry Bannister, Chief Equity Strategist at Stifel, analyzed the stock market performance of excellent companies using the same criteria and compared them to performance of "un-excellent" companies, i.e., companies showing poor historical financial performance.[1] Key results of his research are summarized in the graph below.



Source: Stifel format. Data from Capital IQ, Factset & company annual reports.

[1]Source: "Un-Excellent Portfolios vs. Excellent ones", Barry Bannister and Jesse Cantor, Stifel, July 6, 2015

This graph shows that $1,000 invested in each year over the last 43 years in excellent companies grew to be about $634,000, an annualized return of 6.52%. By contrast, a portfolio consisting of un-excellent companies grew to be $2.6 million, quadrupling the performance of excellent companies, and earning an annualized return of 10.10%. To understand the reasoning behind this staggering difference and its implications, one has to start with the financial performance criteria used by the authors of the book.

Peters and Waterman used six specific financial performance criteria for identifying excellent companies. Two of these criteria prized strong historical growth, three of them rewarded high profitability, and the last one preferred a high ratio of market value to book value. So, a company with high growth, high profitability and high valuation was considered an excellent company. Bannister analyzes as to why un-excellent companies have proven to be excellent stocks. He concludes as follows.

- There is mean reversion in profitability. Un-excellent companies revert to producing higher profits and are rewarded for it. By contrast, excellent companies are not able to achieve the same rate of profit growth.

- Un-excellent companies portfolio has a value bias as it is dominated by stocks in value-oriented sectors (e.g., Financials, Materials, Utilities, Energy). On the other hand, excellent companies portfolio has a growth bias as it is dominated by stocks in sectors generally considered to be growth-oriented (e.g., Technology, Consumer, and Health Care).

- Most of the outperformance of un-excellent companies is derived during periods when economic growth is above average. When growth is anemic, there can be some short and intermediate time periods when un-excellent companies underperform. Such is the case in 2015 because of the skepticism regarding worldwide economic growth.

- Many times, un-excellent companies outperform in Year 2 and 3 after selection, but not in Year 1. This is presumably because in Year 1, the “wall of worry” regarding un-excellent companies continues to weigh on the stocks until earnings recovery sets in.

High Pointe’s stock valuation framework has many similarities but one important difference from the strategy tested by Bannister. Our framework has two of the three dimensions tested by Bannister, namely, growth and valuation. For the third dimension we use “quality” rather than “profitability”. Our use of the quality factor is consistent with discounted cash flow approach, the gold standard of valuation. Moreover, as explained in our client letter from First Quarter 2012, it allows us to incorporate the research that has shown that higher quality companies have actually outperformed low quality companies.

We have suggested to Mr. Bannister that he further his research by segregating the results along the three dimensions used by High Pointe to understand which dimension adds the most value for un-excellent companies. He does see merit to the idea and if he pursues the research, we will share the results in a future client letter.

It is always refreshing to find new research that corroborates our own investment process. It is also a reminder that our approach is not likely to outperform in every environment. Concerns regarding economic growth have clearly weighed on our portfolio this year. We do take comfort in the implications of this research that over time un-excellent companies make for great stocks.

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, 2015

	One Quarter	One Year	Three Years	Since Inception[2]
Large Cap Value	1.8%	5.6%	19.6%	10.1%
Russell 1000 Value Index	0.1%	4.1%	17.3%	6.9%
Large Cap Growth	-1.8%	8.1%	17.1%	8.9%
Russell 1000 Growth Index	0.1%	10.6%	18.0%	3.7%
Small Cap Equity	-2.2%	-5.0%	11.8%	9.3%
Russell 2000 Index	0.4%	6.5%	17.8%	7.6%
International Equity	0.0%	-4.8%	11.5%	3.1%
MSCI AC World ex US Index[3]	0.5%	-5.3%	9.4%	2.0%
Global Opportunity	-0.1%	-0.8%	n/a	8.5%
MSCI AC World Index	0.4%	0.7%	n/a	8.2%

[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; Global Opportunity: October 1, 2013.
[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 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. The **Global Opportunity** composite invests opportunistically in foreign and domestic companies 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). The **MSCI All Country World Index** measures the equity market performance of world's developed and emerging markets including the U.S. Currently the index consisted of 46 countries (23 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 1.8%, outperforming its benchmark, the Russell 1000 Value Index by 1.7%. During the quarter, security selection was strong in the Financial and Material sectors, but was partially offset by weak stock selection in the Consumer Discretionary sector.

In the Financial sector, our investments in the Diversified Financial Service and Investment Banking industries benefitted as expectations regarding an increase in interest rates took hold. Our investment in the Commodity Chemical industry performed well despite a difficult industry environment. Similarly, our investment in Farm Machinery controlled expenses well in an otherwise weak market. In the Industrials sector, our investment in the Industrial Conglomerate industry benefitted from value-enhancing restructuring.

During the quarter, we reduced our investment in the Technology sector and increased our investment modestly in the Energy sector. We sold a Technology Hardware industry investment that performed well as a result of strong product innovation and growth. We invested the proceeds in the Oil & Gas Exploration & Production industry. In the Consumer Discretionary sector, we repositioned our investments out of Apparel Retail in favor of a diversified Publishing industry company with broadcasting and real estate assets.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of -1.8%, lagging its benchmark, the Russell 1000 Growth Index, by 1.9%. During the quarter, security selection was weak in the Consumer Discretionary and Technology sectors.

In the Consumer Discretionary sector, our investment in the Apparel Retail industry struggled with turnaround efforts as one of its brands had weak merchandise assortment. The other brands continue to show improvement and we believe this is a temporary and fixable issue. In the Technology sector, our investments in the Semiconductor and Electronic Equipment industries suffered in a weak industry environment. On the positive side, our investments in the pharmaceutical industry benefitted from strong growth and execution.

During the quarter we increased our investment in the Industrial sector and decreased our investment in the Consumer Discretionary sector. In the Consumer Discretionary sector, we took profits in our Home Improvement and Automotive Retail industry investments. We invested the proceeds in the Electrical Component and Auto Part industries. In the Technology sector, we repositioned our investments out of Semiconductors and into Outsourced Services.

Small Cap Equity

High Pointe's Small Cap Equity strategy produced a return of -2.2% during the quarter, trailing its benchmark, the Russell 2000 Index by 2.6%. Stock selection was weak in the Healthcare and Consumer Staples sectors but was partially offset by strong stock selection in the Financials sector.

In the Healthcare sector, our investment in the Life Sciences industry underperformed as equipment orders were delayed. In the Consumer Staples sector, we sold our investment in health foods which had suffered as costs rose and risks increased with management turnover. Our investment in the Electronic Equipment industry was hurt as foreign demand weakened. On the positive side, our investment in the mortgage industry benefitted from a strong environment and reduced regulation.

During the quarter we increased our investments in the Consumer Discretionary and Industrial sectors and reduced our investments in the Healthcare and Energy sectors. In the Energy sector, we sold investments in renewable oils. In the Technology sector, we took profits as our investment in the mortgage software industry experienced strong adoption. We invested the proceeds in the Apparel Retail, Auto Part, Distributors, Machinery and Software industries.

International Equity
High Pointe's International Equity strategy produced a return of 0.0% lagging its benchmark, the MSCI All Country World ex-US Index, by 0.5%. Stock selection in the Technology sector added value but was more than offset by weak stock selection in the Industrials sector.

Our investment in Emerging Market mobile gaming industry performed well with strong growth. The portfolio also benefitted when our investments in the European Logistics and UK Integrated Oil and Gas industries agreed to be acquired at significant premiums. On the other hand, our investment in European Luxury Goods struggled with lower profitability. In addition, our Communication Equipment holding faced weak spending by its U.S. based telecom clients.

During the quarter, we increased our investments in the Telecommunications sector and decreased our holdings in the Technology sector. We also reduced our investment in Europe and increased our investment in the UK. We took profits as an Emerging Market Semiconductor industry investment met our price target. The proceeds were reinvested in the UK Integrated Telecommunication industry and Emerging Market Education Services industry.

Global Opportunity
High Pointe's Global Opportunity strategy produced a return of -0.1%, trailing its benchmark, the MSCI All Country World Index by 0.5%. The portfolio benefitted when our investment in the UK Integrated Oil and Gas industry agreed to be acquired at a significant premium. In the Industrial sector, our investment in US Farm Machinery controlled expenses well in a tough environment. On the other hand, our investments in the US Semiconductor and Electronic Equipment industries suffered from weak industry environments.

During the quarter, we increased our investment in the Financial and Industrials sectors and decreased our investments in the Healthcare and Consumer Staples sectors. We also reduced our investments in Continental Europe and the UK and increased our investments in the U.S.

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In aggregate, this was a weak quarter for High Pointe. We have had them before too. As described at the beginning, our exposure to value-oriented stocks, especially those in cyclical industries, has weighed on performance. Many of our companies fit the definition of "un-excellent" companies that we believe are "excellent" stocks, and we look for a rebound in them as the situation in Europe and elsewhere returns to normalcy.