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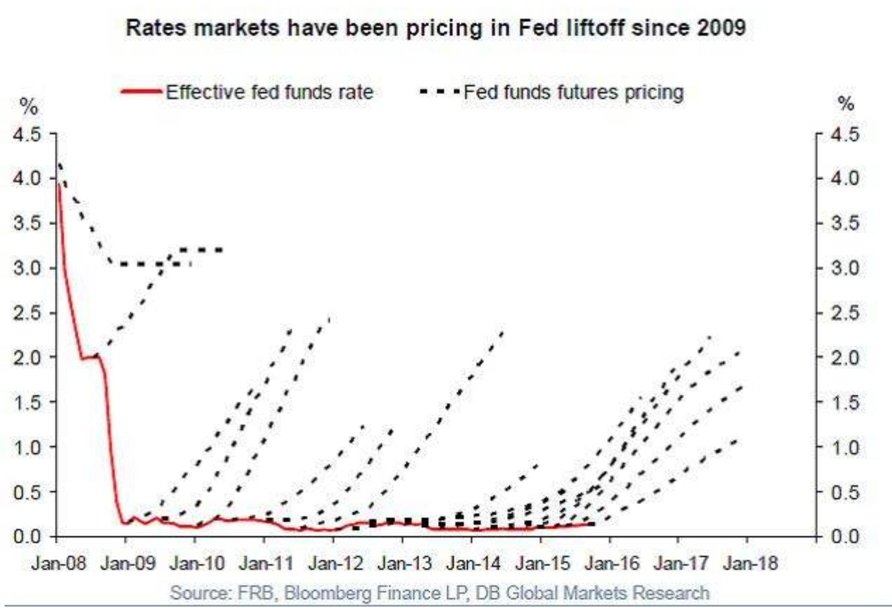
Innovate. Deliver.

High Pointe

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

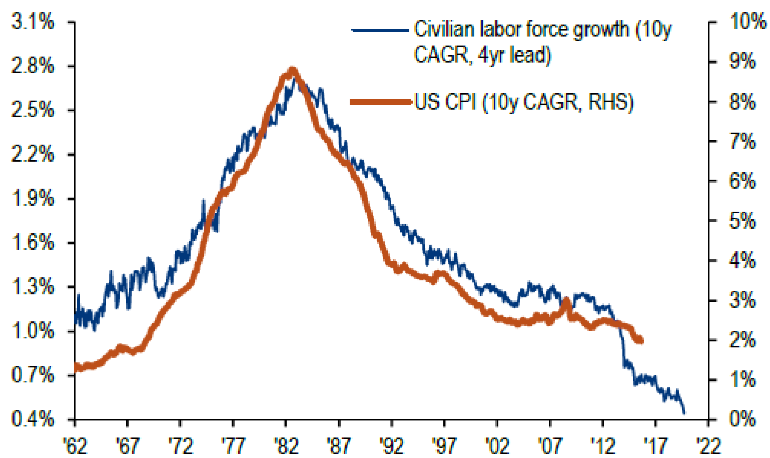
"Water, Water, Every Where,
Nor Any Drop to Drink."
Samuel Taylor Coleridge
The Rime of the Ancient Mariner (1798)

Investors have been consistently wrong about predicting the direction of interest rates and, in particular, about the Federal Reserve Bank raising its benchmark rate, called the Fed Funds Rate. Here is the proof. The red line in the chart below shows the Fed Funds Rate. The dotted blue lines represent investors' collective predictions about the Fed Funds Rate over the next three years. These rising curves show that investors have consistently predicted a rise in the Fed rate but the Fed has not obliged, for good reasons as explained below.



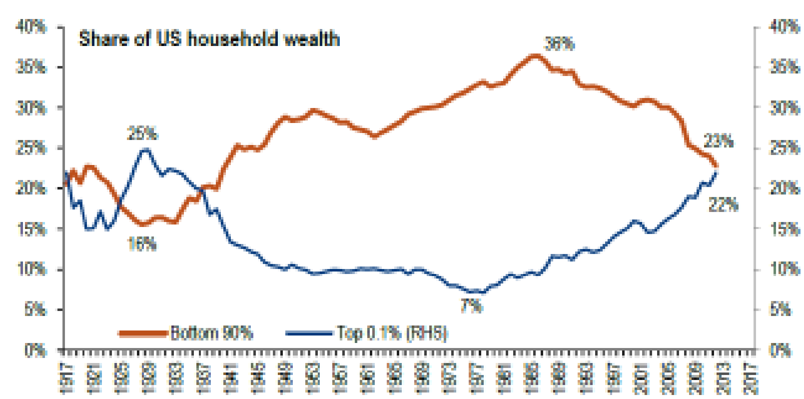
Source: "Wall Street is consistently wrong about the Fed's intentions" Ellie Ismailidou, published in MarketWatch, October 19, 2015

The main reasons why the Fed has not raised interest rates are that economic growth is anemic and inflation is too low. Both of these phenomena are partly explained by demographics as shown in the chart below. It shows the growth rate of the U.S. working population (depicted by the blue line) side by side with inflation (depicted by the red line). During the 1960s and 1970s, the working population was growing at an increasingly higher rate and so was inflation. Since the 1980s, the growth rate of the working population has slowed decisively and so has inflation. The blue line is projected forward five years and it is clear that the dampening effect of demographics on inflation is likely to continue. (This chart should not be interpreted to imply a definitive prediction of lower inflation because inflation is impacted by more factors than just demographics.)



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg, Haver

The Fed has kept interest rates low in hopes of avoiding deflation and generating growth. It has succeeded in avoiding deflation so far it has not been successful in generating sufficient growth. Moreover, low interest rates have led to a rise in the prices of stocks and other financial assets. That, in turn, has accelerated a trend towards a level of inequality of wealth not seen since the 1920s.

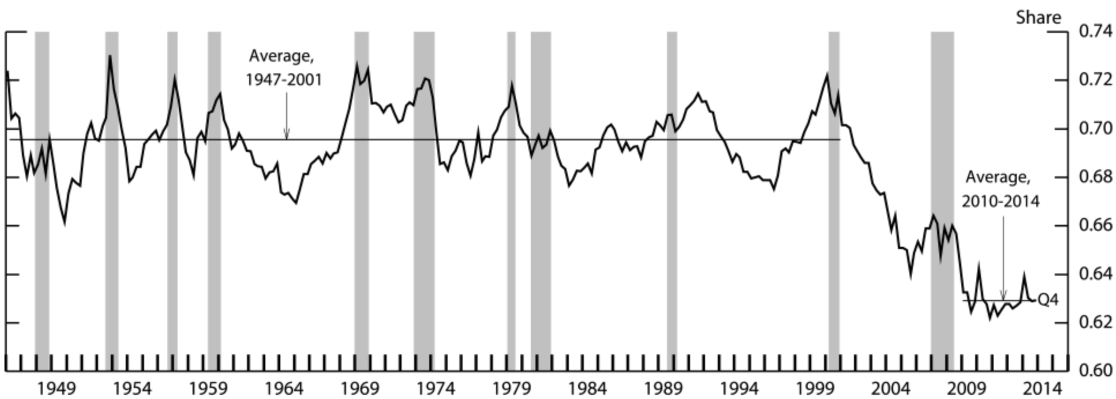


Source: BofA Merrill Lynch Global Investment Strategy, Emmanuael Saez & Gabriel Zucman - 2015

Unfortunately, rising inequality also impedes economic growth because those with high wealth and income spent a smaller proportion of their newly gained wealth those with lower levels of wealth and income.

Anecdotal evidence also hints at the possibility that rapid technological advancements over the last few years may also be weighing on the working class as a bigger share of new income goes to capital instead of labor. The chart below shows labor's share of national income. The sharp decline in labor's share from a stable 70% for 50 years to 63% roughly since the advent of the internet is quite apparent.

Labor's Share of National Income



Source: FEDS Notes, The Labor Share of Income and Equilibrium Unemployment, by Andrew Figura and David Ratner, June 8, 2015

Conventional wisdom a few years ago was that routine and repetitive jobs will be automated. Improvements in technology are making us re-think that limitation. Imagine a situation where robots serve you fast food, drones deliver parcels, driverless cars eliminate the need for taxi drivers, and a "sharing economy" means the demand for cars and hotel rooms declines. That is a lot of jobs up for elimination as technology progresses.

So, the conundrum for the Fed continues. How to generate growth and inflation? By now, most experts agree that even though we are awash in a sea of money it is not doing us much good, similar to the predicament of the mariner in Coleridge's epic poem who was surrounded by sea water but had none to drink. Some experts have suggested government spending on infrastructure and direct measures of transferring wealth to the poor as a better means to achieve this goal. It is unlikely that the political situation in the United States will let that happen any time soon. However, the resurgence of some leftist parties in Continental Europe, UK, and Canada might let us see this experiment play out and its consequences. (As we write this newsletter, Justin Trudeau has just been elected the next prime minister of Canada.)

As we look for the implications of these data points for investing, we would note in light of weak inflation expectations, bonds continue to be worth investing despite low bond yields. On the equity side, swaths of industries (e.g. rental cars) deserve to be watched carefully for technological obsolescence. Interestingly, one sector that does not seem to be impacted adversely by technological progress is healthcare. If anything, the better the technology, the longer people will live, and the more healthcare they will consume.

The issues discussed here are complex and the evidence we have shared here is only partial. Many other things matter too. We will continue to collect more data and evidence in our quest for well-reasoned investing.

HIGH POINTE

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 September 30, 2015

	One Quarter	One Year	Three Years	Since Inception[2]
Large Cap Value	-10.8%	-6.2%	12.6%	9.2%
Russell 1000 Value Index	-8.4%	-4.4%	11.6%	6.3%
Large Cap Growth	-9.5%	-3.2%	11.0%	8.1%
Russell 1000 Growth Index	-5.3%	3.2%	13.6%	3.3%
Small Cap Equity	-15.5%	-11.7%	4.5%	8.1%
Russell 2000 Index	-11.9%	1.3%	11.0%	6.7%
International Equity	-14.2%	-14.5%	3.2%	1.2%
MSCI AC World ex US Index[3]	-12.2%	-12.2%	2.3%	0.4%
Global Opportunity	-13.0%	-11.9%	n/a	0.2%
MSCI AC World Index	-9.5%	-6.7%	n/a	1.9%

[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
2015 is a weak performance year so far for High Pointe. This year, the biggest driver of stock returns has been price momentum. Stocks that had already risen in price over the previous 12 months continued to go up during the first nine months of 2015, and stocks with inexpensive valuations continued to be out of favor. Data analyzed by Merrill Lynch indicates that a high price momentum portfolio outperformed the broad market by +4.3%, while a portfolio of stocks with lower valuation (forward P/E) underperformed the broad market by -5.4%. This phenomenon has severely hindered our investment strategy which focuses on valuation and does not believe in following the herd to stocks that have already gone up substantially and are expensive. As we start the fourth quarter, early signs are that momentum's run might be ending as value stocks have started to outperform momentum stocks. If that is indeed the turning point, our returns starting the fourth quarter should rebound. Our comments regarding specific strategies follow.

Large Cap Value
High Pointe's Large Cap Value strategy produced a return of -10.8%, lagging its benchmark, the Russell 1000 Value Index by 2.4%. During the quarter, security selection was weak in the Financials and Energy sectors, but was partially offset by strong stock selection in the Technology sector.

In the Financials sector, our investments in the Diversified Financial Services and Investment Banking industries suffered as global market uncertainty increased. Similarly, our investments in the Diversified Chemicals and Farm Machinery industries struggled with agricultural market weakness. On the positive side, our investment in Internet Services benefitted from strong execution and revenue growth. In addition, our investment in the Multi-Utilities industry outperformed as it executed well in a favorable environment.

During the quarter, we reduced our investment in the Consumer Discretionary sector and increased our investment in the Industrials sector. In the Consumer Discretionary sector, we sold a Publishing industry investment that had struggled. We invested the proceeds in the Building Products industry. In the Financial sector, we repositioned our investments out of Custody Banks and into Consumer Finance.

Large Cap Growth
High Pointe's Large Cap Growth strategy produced a return of -9.5%, trailing its benchmark, the Russell 1000 Growth Index, by 4.2%. At the sector level, security selection was weak in the Consumer Discretionary and Healthcare sectors.

In the Healthcare sector, our investment in the Pharmaceutical industry suffered as politicians increased their focus on possible regulation of drug prices. We believe these concerns are transitory driven by the election season and the company is well positioned. In addition, our investment in the Biotechnology industry struggled with weaker sales. In the Consumer Discretionary sector, our investment in the Auto Parts industry faced weak demand. On the positive side, our investment in the Aerospace industry agreed to be acquired for a significant premium.

During the quarter we repositioned our investments out of the Consumer Discretionary sector and into the Technology sector. In the Consumer Discretionary sector, we took profits in our discount retail industry investment. We invested the proceeds in the Healthcare Equipment industry. In the Technology sector, our Application Software industry investment was acquired at a significant premium and we reinvested the proceeds in the Internet Service industry.

Small Cap Equity

High Pointe's Small Cap Equity strategy produced a return of -15.5% during the quarter, lagging its benchmark, the Russell 2000 Index by 3.6%. Stock selection was weak in the Financials and Healthcare sectors but was partially offset as the portfolio benefitted from an underweight in the Materials sector.

In the Healthcare sector, our investment in the health cost management industry struggled as a large government contract was lost to a competitor. In the Financials sector, our investment in the Asset Management industry underperformed as its previously strong growth slowed and profitability weakened but the company's well positioned for the long run. Our investment in the Industrial Machinery industry suffered from a weak agricultural market environment and a strong dollar. On the positive side, our investment in software for the insurance industry benefitted as it agreed to be acquired for a significant premium.

During the quarter we increased our investments in the Consumer Staples and Financials sectors and reduced our investments in the Industrials and Healthcare sectors. In the Healthcare sector, we repositioned our investments out of Healthcare Equipment and into the Life Sciences Tools industry. In the Technology sector, we sold a telecom expense management software company that failed to generate the growth we anticipated and reinvested the proceeds in the Semiconductor industry. We also increased our investments in the Packaged Foods and natural and organic food industries.

International Equity

High Pointe's International Equity strategy produced a return of -14.2% trailing its benchmark, the MSCI All Country World ex-US Index, by 2.0%. Stock selection in the Consumer Discretionary and Materials sectors detracted value but was partially offset by strong stock selection in the Telecommunications sector.

In the Consumer Discretionary sector, our investment in the Japanese Consumer Electronics industry struggled with a weak domestic spending environment. In the Materials sector, our investment in the mining industry suffered in the face of weak commodity prices. Our investment in Diversified Banks in the United Kingdom faced concerns about exposure to emerging market currencies. On the positive side, our investment in United Kingdom Household Products industry benefitted from strong execution and growth.

During the quarter, we increased our investments in the Technology sector and decreased our holdings in the Consumer Discretionary sector. We also reduced our investment in the UK and increased our investment in the Pacific-Basin. Specifically, we sold an Australian financial services company that had performed well in favor of a Hong Kong life insurance company. In addition, we repositioned our Japanese investments out of an advertising company that had benefitted from strong execution and global growth and into Electronic Components.

Global Opportunity

High Pointe's Global Opportunity strategy produced a return of -13.0%, lagging its benchmark, the MSCI All Country World Index by 3.5%. Our investment in a UK mining company suffered as commodity prices fell and concerns about its debt level increased. In the Consumer Discretionary sector, our investment in US Media industry declined as investors shunned the whole industry after a weak report from one of the companies. We are comfortable with our investment in this industry as it has company-specific catalysts that should allow it to offset industry headwinds. Lastly, our investment in the US Aerospace industry agreed to be acquired at a significant premium.

During the quarter, we increased our investment in the Healthcare and Technology sectors and decreased our investments in the Materials and Consumer Discretionary sectors. We also reduced our investments in the UK and increased our investments in North America.

Thank you, as always, for the opportunity to manage your assets!