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High Pointe

DATE: January 11, 2016
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Evolving with the Times

In response to a critic who accused John Maynard Keynes of being inconsistent, he is reputed to have said "When the facts change, I change my mind. What do you do, Sir?"

Whether Keynes actually said it or not, I have always liked the quote because it is so apt for investing. It is important to have a good, steady investment philosophy, but it is equally important to adapt to the changing world. In recent periods, some of the changes in the investing world are so profound that it is worth restating our long term investment philosophy and then describing how we are adapting to take advantage of the opportunities presented by the changing times.

The Tried and True

High Pointe's management of balanced portfolios for individuals and families has been guided by an investment philosophy based on several tried and true principles of investing as summarized below.

- At the outset, determine an asset allocation policy consistent with one's investment time horizon and risk tolerance.
- Have the discipline to stick with the asset allocation policy through good and bad times, and rebalance the portfolio to take advantage of the opportunities created by market volatility.
- Diversify the portfolio to mitigate security-specific risk.
- Keep costs low by avoiding funds with high fees, sales loads and marketing (12b-1) fees.
- Implement the investment strategy in a way that minimizes taxes
    - Use high income securities in tax-deferred accounts and tax-exempt securities in taxable accounts
    - Keep portfolio turnover low
    - Minimize short-term capital gains and generate most of the portfolio return in the form of long-term capital gains and dividends which are taxed at lower rates.
    - Harvest short-term losses as needed to offset any short-term capital gains
- Do not use leverage or derivatives that can compound the risks of the underlying portfolios.
- Be skeptical of insurance company offerings (for reasons outlined in the next section).

Recent Developments and Their Implications
As good as these true and tried principles are they have historically left small gaps in overall portfolios, sometimes because of valuation and sometimes because of lack of availability of reasonable cost investment vehicles to fill the gaps. Things are changing. For one, the economic environment has changed quite a bit. The unprecedented monetary intervention by central banks has put us in uncharted territory, where the probability of high inflation or deflation is higher than it used to be. Secondly, the availability of investment vehicles has improved. In particular, exchange-traded fund (ETF) offerings have expanded beyond plain vanilla index funds to more specialized funds that have the potential to fill some of the gaps.

Below, we discuss the portfolio gaps in light of these changes and how the gaps might be filled.

- **Lack of specific or direct protection from either high inflation or deflation**
  Stocks, over a long period, are expected to keep up with high inflation, should it occur. However, over short and intermediate periods, they are unlikely to do well in an unexpectedly high inflation scenario. And, of course, bonds are likely to perform poorly in high inflation scenarios. There are two options for dealing with high inflation over short and intermediate terms. One can invest in Treasury Inflation-Protected Securities (TIPS) which provide direct inflation protection. Alternatively, one can invest in real assets, especially commodities, which exhibit a positive correlation with inflation. Neither TIPS nor commodities have been attractive investments from a valuation perspective over the last several years and we have not used them. So, their absence from the portfolio has been beneficial. Looking forward, however, we will evaluate their merits primarily as insurance against inflation rather than return enhancing assets.

  In a deflationary time period, bonds should do well; however, not all bonds will do well. Treasury bonds will clearly outperform, but low quality corporate bonds may not do well because their default risk will likely increase and mortgage backed bonds may be impacted by other factors like prepayment risk. So, options for dealing with deflation are limited primarily to Treasury bonds. Traditionally, we have invested more in corporate, mortgage-backed, high yield, and emerging market bonds, than in Treasury bonds in order to enhance returns. However, for insurance against deflation, we will explicitly consider the use of long-term Treasury Bonds.

- **Lack of "guaranteed" returns**
  Insurance companies offer investment products that are "guaranteed". We have been skeptical of insurance company offerings. This is despite the fact that the concept of insurance has merit because of the benefit of pooling of risks and because these products offer payoffs that have virtually no correlation to other assets such as stocks as bonds. Our skepticism is justified by the high and/or hidden costs of most insurance-oriented investment products, as well as restrictions and penalties associated with them. Lately, however, one specific insurance product has come up on our radar screen that merits attention. The product is "longevity insurance." As life expectancy increases because of better healthcare, the risk that we may outlive our assets also increases. Longevity insurance pays a guaranteed amount beyond a certain age (e.g., after attaining the age of 80 years) until death, in return for an upfront investment (premium). This type of payoff is not available from any traditional asset such as stocks, bonds, real estate, or commodities.

- **Unwillingness to take advantage of certain leverage-based strategies**
  It has been well known in institutional circles that at times judicious use of leverage can enhance return without a commensurate increase in risk. For example, investors contemplating an exposure to ten-year duration bonds can do better by doubling their exposure to five year bonds using derivatives. It has not been logical or feasible to use such strategies in individual client portfolios because of the risks associated with the use of derivatives. Now, some ETFs based on such strategies are beginning to be offered and these have the potential to allow individual investors to get the desired exposure while taking risks similar to the risk of owning stocks.

- **Few assets with potential for appreciation during a crisis of confidence**
  During times when investors lose confidence in markets and risky assets, long-term Treasury bonds and hard assets such as gold can offer some shelter. While it is not logical to design a long-term investment strategy based solely on this pessimistic scenario, having some exposure to these two asset classes can be justified for protection during crisis.

To summarize, as facts change, so will we. Unlike Charlie Chaplin in *Modern Times*, we welcome the challenge and opportunities brought by modern times.

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, 2015

	One Quarter	One Year	Three Years	Since Inception[2]
Large Cap Value	6.6%	-4.2%	14.4%	9.4%
Russell 1000 Value Index	5.6%	-3.8%	13.1%	6.5%
Large Cap Growth	5.1%	-3.1%	14.0%	8.3%
Russell 1000 Growth Index	7.3%	5.7%	16.8%	3.7%
Small Cap Equity	3.2%	-16.4%	4.7%	8.2%
Russell 2000 Index	3.6%	-4.4%	11.7%	6.8%
International Equity	3.1%	-8.6%	1.9%	1.5%
MSCI AC World ex US Index[3]	3.2%	-5.7%	1.5%	0.7%
Global Opportunity	5.3%	-6.9%	n/a	2.5%
MSCI AC World Index	5.0%	-2.4%	n/a	4.0%

[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 6.6% for the quarter, outperforming its benchmark, the Russell 1000 Value Index by 1.0% for the quarter, but trailed it by 0.4% for the year. During the year, security selection was strong in the Industrials and Healthcare sectors, but was partially offset by weak stock selection in the Consumer Discretionary and Energy sectors.

During the year, our investment in the Industrial Conglomerates industry benefitted from value-enhancing restructuring and strong execution. In addition, our investment in the Employment Services industry performed well with growth despite a difficult economic environment. In the Healthcare sector, our Managed Care industry investment executed well in a favorable market. On the other hand, our investment in the Semiconductor industry struggled as PC sales remained weak.

During the quarter, we decreased our investments in the Industrials and Financials sectors and increased our investments in the Technology, Consumer Discretionary and Healthcare sectors. In the Financials sector, we reduced our exposure to insurance and increased our exposure to REITs. In the Industrial sector, we sold an Industrial Conglomerate and a Building Product company that had performed well and repositioned our holdings into construction. In the Consumer Discretionary sector, we sold a luxury handbag company that had struggled in favor of Auto Parts and Leisure Products. Finally, in the Healthcare sector, we took profits in the Managed Care and Equipment industries and invested the proceeds in competitors and the Biotechnology industry.

Large Cap Growth
High Pointe's Large Cap Growth strategy produced a return of 5.1% during the quarter, trailing its benchmark, the Russell 1000 Growth Index by 2.2% for the quarter, and by 8.8% for the year. During the year, stock selection was weak in the Consumer Discretionary and Healthcare sectors, but was partially offset by strong security selection in the Materials sector. A slight overweight to Energy also held back performance.

During the year, our investment in the Apparel Retail industry struggled with poor merchandise assortment. In the Healthcare sector, our investment in the Pharmaceutical industry suffered as politicians focused on possible increased regulation of drug prices. In the Financials sector, our Asset Management industry holding's strong long-term performance deteriorated and the weak equity market weighted on the prices of asset management firms. On the other hand, our investment in Internet Services benefitted from strong execution and revenue growth and our investment in the cruise industry profited as bookings increased and oil prices weakened.

During the quarter we increased our investments in the Consumer Discretionary sector and decreased our investments in Industrials and Healthcare sectors. In the Industrials sector, we sold our investment in the Aerospace industry after it agreed to be acquired for a significant premium. In addition, we reduced our investment in the Life Sciences industry and reinvested the proceeds in the Internet Services industry. In the Technology sector, we sold our investment in Electronic Manufacturing Services which had profited from strong execution and beneficial

M&A. We reinvested the proceeds in the boating, motorcycles, jewelry and internet retail industries.

Small Cap Equity
High Pointe's Small Cap Equity strategy produced a return of 3.2% during the quarter, lagging its benchmark, the Russell 2000 Index by 0.4% for the quarter, and by 12.0% for the year. During the year, stock selection was weak in the Healthcare and Consumer Discretionary sectors. However, this was partially offset as an underweight in the Materials sector and an overweight in the Technology sector both added value.

During the year, our investment in the discount retail industry struggled with turnaround efforts as inventory and sales were weak. In the Healthcare sector, our investment in the health cost management industry suffered as a large government contract was lost to a competitor. In addition, our investment in the foreign exchange brokerage industry required a rescue package after the Swiss government removed its currency peg to the Euro and the Company's clients suffered trading losses. On the positive side, our investment in the mortgage software industry benefitted from strong growth as its industry leading product was in high demand. Furthermore, our ski resort investment performed well as its broad mountain offerings attracted skiers to its season passes.

During the quarter we increased our investment in the Healthcare sector and reduced our investment in the Industrials sector. We took profits as our machinery industry investment agreed to be acquired at a significant premium and reinvested the proceeds in the Pharmaceutical industry.

International Equity
High Pointe's International Equity strategy produced a return of 3.1% during the quarter, trailing its benchmark, the MSCI All Country World ex-US Index, by 0.1% for the quarter, and by 2.9% for the year. During the year, stock selection was weak in the Financials and Healthcare sectors but was partially offset by strong security selection in the Technology sector. In addition, our underweight in the Materials and Energy sectors also added value.

During the year, our investment in Diversified Banks in the United Kingdom faced concerns about exposure to emerging market currencies and the mining industry. In the Healthcare sector, our holding in the North American Pharmaceutical industry suffered as questions arose about its pricing and business practices. In the mining industry our United Kingdom holding struggled with weak commodity prices. On the positive side, our emerging market Internet Services investment benefitted from strong growth in mobile gaming. In addition, our investment in the Japanese Advertising industry performed well in a favorable market.

During the quarter, we increased our holdings in the Technology and Financials sectors and decreased our investments in the Industrials sector. We also repositioned our investments out of continental Europe and the UK and into emerging markets and North America. Specifically, we sold a European Industrial Conglomerate and Electrical Component company as well as other positions received in corporate actions. We reinvested the proceeds in a Swiss bank and North American Pharmaceutical company.

Global Opportunity

High Pointe's Global Opportunity strategy produced a return of 5.3% for the quarter, exceeding its benchmark, the MSCI All Country World Index by 0.3% for the quarter, but lagging it by 4.5% for the year. During the year, our investment in a UK mining company suffered along with commodity prices. In the Technology sector, our investment in US Semiconductors struggled as PC sales failed to improve. On the positive side, our US Internet Services investment benefitted from strong revenue growth. In addition, our investment in emerging market Education Services experienced countercyclical growth as its economy slowed.

During the quarter, we increased our investment in the Technology and Financials sectors and decreased our investments in the Industrials and Healthcare sectors. We also reduced our investments in North America and increased our investments in emerging markets.

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2015 was undoubtedly one of our weaker years from a performance perspective as momentum stocks such as Amazon and Netflix marched skywards while value-oriented stocks were ignored. We are confident that that value stocks will once again shine and our patience will be rewarded. Thank you, as always, for the opportunity to manage your assets!