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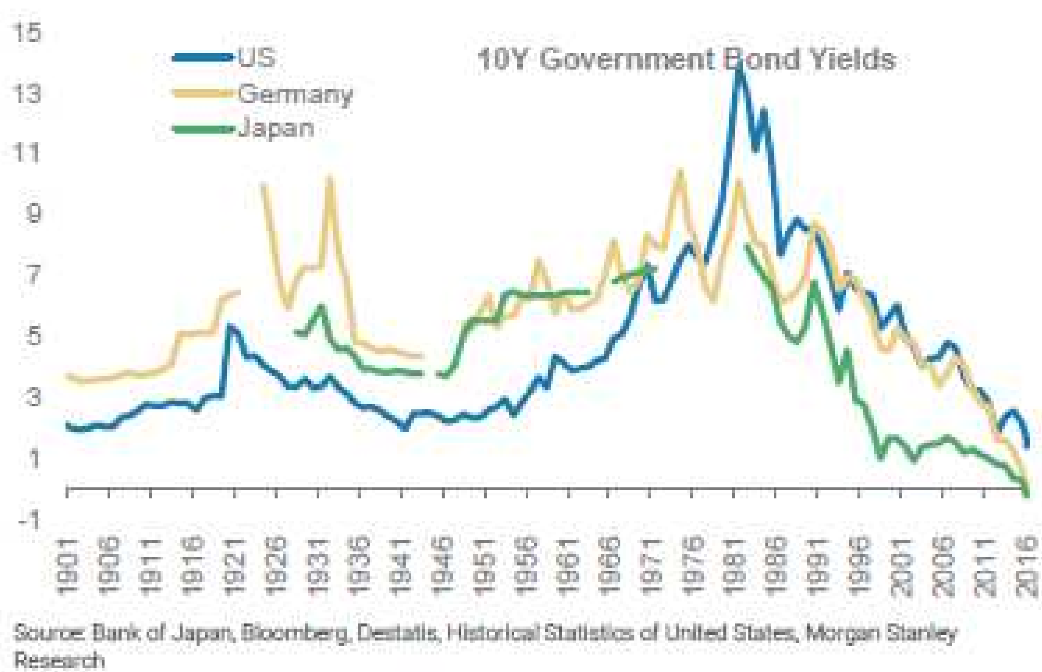
High Pointe

DATE: July 21, 2016
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

The Twilight Zone

In 1969, Milton Friedman suggested a thought experiment of dropping money from helicopters for people to pick it up. He used that vivid imagery to make the point that central bankers have the ability, if needed, to increase consumer demand and to generate inflation by doling out newly printed money.

Ever since the financial crisis in 2007-2008, central banks around the world have been trying to increase consumer demand and inflation. They have lowered interest rates believing that low interest rates will spur more borrowing and higher asset prices, and that will stimulate growth and inflation. They have succeeded in lowering interest rates to the depths never before experienced in the 116-year history shown below. (And, yes, interest rates in Japan and Germany are now negative!)



Source: Morgan Stanley, *Global Macro Summer Outlook, Published on July 17, 2016*

Interest rates are so low in some countries that investors are willing to lend their governments $100 today with the accompanying guarantee that they would get back less than $100 in a few years. Even Lewis Carroll could not have imagined such a wonderland.

Investors are willing to do something so apparently illogical, for two very logical reasons – one is fear and the other is necessity. Fear reflects lack of trust in any other asset. Necessity refers to the need to own assets that move inversely to interest rates in order to hedge liabilities (e.g., pension liabilities).

Small individual investors at least have the "luxury" of being able to hoard their money in a mattress instead of investing at negative interest rates. Larger investors who make up the bulk of the market have no such alternative because most money exists only in an electronic form, not physical. Moreover, storing large amounts of physical money does have costs and risks associated with it.

Even though the central banks have succeeded in lowering interest rates to level never seen before, their experiment is not working. Lower interest rates are not generating the desired level of economic growth and inflation.

Central bankers are very afraid of deflation (for good reasons) that their next battle tool might just be dropping money from helicopters. In today's electronic age, it would be easy for the central bank to credit every individual's checking account with a few hundred dollars. In theory, this would increase consumption and lead to economic growth as people spend their windfall. But this theory might not work in real life for psychological reasons. Raghu Rajan, the world renowned governor of the central bank of India, explained this in recent lecture at the London School of Economics. He said:

"Somebody getting this money and seeing the central bank governor throwing money out of the window will say, 'Is this guy crazy? Has the world gone nuts? I'd better save much of this because I'm not sure what will happen.' "

To avoid the possibility of people hoarding their new found money, central bankers would likely print the money and hand it to governments who will spend it on public projects. By spending the money, the government would put it in people's pocket without stoking fear.

Central bankers' actions, while extreme, are not without reason. Their mandate is to maintain price stability and full employment. A 2% inflation (plus or minus a bit) is considered the equivalent of price stability. Anything less than 1% sends warning bells about potential deflation and encourages consideration of strategies like helicopter money.

This kind of thinking seemed unimaginable just a few short years ago. However, we live in extraordinary times and thinking about previously unimaginable scenarios is quite rational. Driven by fear of deflation and having little knowledge of the consequences of untested central bankers' actions, we are entering a zone that Rod Serling described at the beginning of his famous TV show, albeit in a different context. He said:

"There is a fifth dimension beyond that which is known to man . . . it lies between the pit of man's fears and the summit of his knowledge . . . It is an area which we call the Twilight Zone."

As we enter the twilight zone, one might be tempted to hunker down – save and not take any risks. However, that is not an optimal position for two reasons. One, saving everything and not investing simply ensures that the purchasing power of money will be gradually eroded so long as there is some inflation. Secondly, continuing intervention by central banks just might continue to raise stock prices further for quite some time to come. So, there can be a significant opportunity cost to being out of the market.

Therefore, instead of hunkering down, one should test all aspects of his or her portfolio for soundness. At the asset allocation level, it would be wise to be a bit more conservative than before, knowing that asset prices have been supported to some extent by central bank interventions. For insurance against a scenario where people might lose faith in central bankers and governments, it may also be logical to have some exposure to physical gold which historically has performed well in turbulent times. Within equities the usual safe haven stocks in Consumer Staples and Utilities sectors are unfortunately quite expensive and as a result do not offer sufficient protection. Instead, investing in less expensive, high quality, cyclical stocks appears to be a more logical option, in our opinion.

Current times do warrant extra vigilance for the reasons articulated above. That is what we are practicing at High Pointe for our clients.

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, 2016

	One Quarter	One Year	Five Years	Since Inception[2]
Large Cap Value	-0.1%	-5.5%	10.1%	9.2%
Russell 1000 Value Index	4.6%	2.9%	11.4%	6.7%
Large Cap Growth	-1.8%	-6.9%	10.1%	7.9%
Russell 1000 Growth Index	0.6%	3.0%	12.4%	3.7%
International Equity	-2.7%	-15.8%	0.9%	1.0%
MSCI AC World ex US Index[3]	-0.6%	-10.2%	0.1%	0.6%
Global Opportunity	-0.4%	-11.8%	n/a	0.6%
MSCI AC World Index	1.0%	-3.7%	n/a	3.7%

[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; 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* ***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* ***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
A fundamental tenet of our investment strategy has been to invest in value stocks and shun expensive, momentum stocks. This strategy has a wonderful performance record since our inception as well as decades periods prior to that. However, the past few years have been unkind for value stocks. We plan to stay the course with our battle tested strategy despite weak recent results because that is where valuations, and prospective returns, are most attractive.

Large Cap Value
High Pointe's Large Cap Value strategy produced a return of -0.1% for the quarter, lagging its benchmark, the Russell 1000 Value Index by 4.7%. We have underweighted several sectors that are perceived by many as safe but are overvalued in our opinion. These include Utilities, Consumer Staples and Telecommunications. During the second quarter fear temporarily gripped the markets, especially when the Brexit vote occurred, and these so-called safe sectors performed better than the rest of the market. We are taking this opportunity to further reduce our exposure to these overvalued sectors and instead investing in less expensive, high quality companies in the Technology, Healthcare and Consumer Discretionary sectors.

At the individual stock level, our investment in the Auto Parts industry declined with the rest of the industry as outlook for future car sales dimmed a bit. Our view is that our investment is focused on improving fuel efficiency, a secular growth theme, and therefore it will be more resilient than the rest of the Auto Parts industry. We also continue to wait patiently for our investment in the Casino industry to pay off as consumer traffic in Macau has not recovered yet. In the mean time, we are getting paid a 6% dividend yield on this investment to wait. On the positive side, our investment in the Fertilizers industry performed well as a competitor made an offer to acquire our company at a premium.

During the quarter, we increased our investments in the Healthcare and Financials sectors and decreased our investments in the Utilities sector. The reduction in the Utilities sectors was achieved by selling an investment that had performed well and reached past fair valuation. We sold a position in the Semiconductor Equipment industry that had performed well because of excellent growth. We repositioned our investments in the Automotive Retail, Apparel and Railroads industries. In the Healthcare sector, we repositioned our Managed Healthcare investments and increased our investment in the Healthcare Facilities industry. In addition, in the Financials sector we reallocated our Asset Management investment into Custody Banks and increased our investment in Real Estate Services.

Large Cap Growth
High Pointe's Large Cap Growth strategy produced a return of -1.8%, trailing its benchmark, the Russell 1000 Growth Index by 2.4%. Security selection was weak in the Consumer Discretionary and Financials sector but was partially offset by strong stock selection in the Healthcare sector.

In the Consumer Discretionary sector, our investment in the Cruise Line industry suffered as economic uncertainty in Europe dragged down the leisure industry. In the Technology sector, our investment in the Technology Hardware industry struggled with weakness in emerging markets. On the positive side, our investment in the Healthcare Equipment industry performed well as product innovation drove growth forecasts higher. In the Materials sector, our Fertilizer industry investment benefitted as a competitor made an offer to acquire the company at a premium.

During the quarter we decreased our investments in the Materials and Consumer Discretionary sectors and increased our investments in the Healthcare sector. In the Materials sector, we took profits as our investment in the Industrial Gases industry was acquired for a significant premium. In the Healthcare sector, we sold an investment in the Pharmaceuticals industry that had struggled.

International Equity
High Pointe's International Equity strategy produced a return of -2.7%, lagging its benchmark, the MSCI All Country World ex-US Index, by 2.1%. Stock selection was weak in the Consumer Discretionary and Materials sectors but was partially offset by strong security selection in the Industrials sector.

In the Consumer Discretionary sector, our holding in the United Kingdom Cable industry struggled with macroeconomic concerns in Britain and Europe. Similarly, our investments in European Automobile Manufacturers suffered as concerns arose about peak auto sales. Our investment in the Communications Equipment industry declined as emerging market sales slumped. On the positive side, our emerging market Internet Software and Services investment continued to execute well with strong mobile gaming sales.

During the quarter, we increased our holdings in the Healthcare sector and decreased our investments in the Industrials and Financials sectors. We also modestly repositioned our investments out of Europe and into emerging markets to take advantage of lower valuations. In the Industrials sector, our investment in European Logistics was acquired by a competitor for a significant premium. We also repositioned the portfolio out of North American Pharmaceuticals and into emerging market Internet Retail.

Global Opportunity
High Pointe's Global Opportunity strategy produced a return of -0.4%, trailing its benchmark, the MSCI All Country World Index by 1.4%. In the Consumer Discretionary sector, our investment in the UK Cable industry suffered as economic concerns increased. In the Technology sector, our investment in the North American Technology Hardware industry encountered disappointing sales growth. On the positive side, our US Pharmaceutical investment experienced better than expected sales and drug expansion opportunities. In addition, our investment in US Life Sciences Tools benefitted from strong execution.

During the quarter, we increased our investments in the Healthcare and Consumer Staples sectors and decreased our investment in the Technology sector. We also reduced our investments in North America and increased our investments in Europe and the UK to take advantage of the valuation opportunities created by Brexit.

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As the temporarily dislocations caused by Brexit dissipate, we are beginning to see improved trends already in the third quarter. We look forward to reporting and discussing them with you in October. Thank you for allowing us to be stewards of your capital.