High Pointe Capital Management, LLC
One North LaSalle, Suite 2001
Chicago, Illinois 60602
312.726.2500
312.726.6100 fax
www.highpointecapital.com

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High Pointe

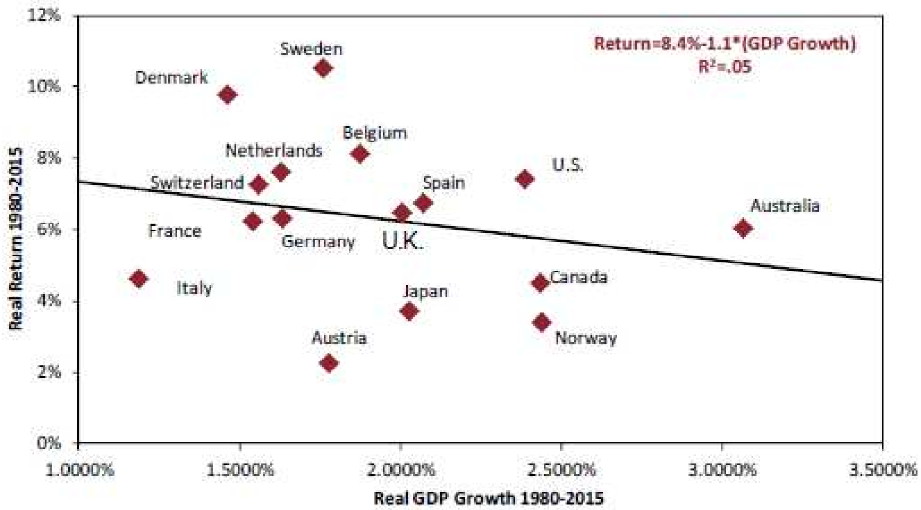
DATE: October 13, 2016
TO: Clients
FROM: Gautam Dhingra
RE: Economic and Portfolio Review

Cheap Chic

One day last month at the dinner table someone asked "which country is next in line to take the economic prosperity baton from China." Quite quickly, the consensus around the table emerged that Indonesia and India are the best candidates. Both countries are large, have favorable demographics (plenty of well-educated young people) and new business friendly governments.

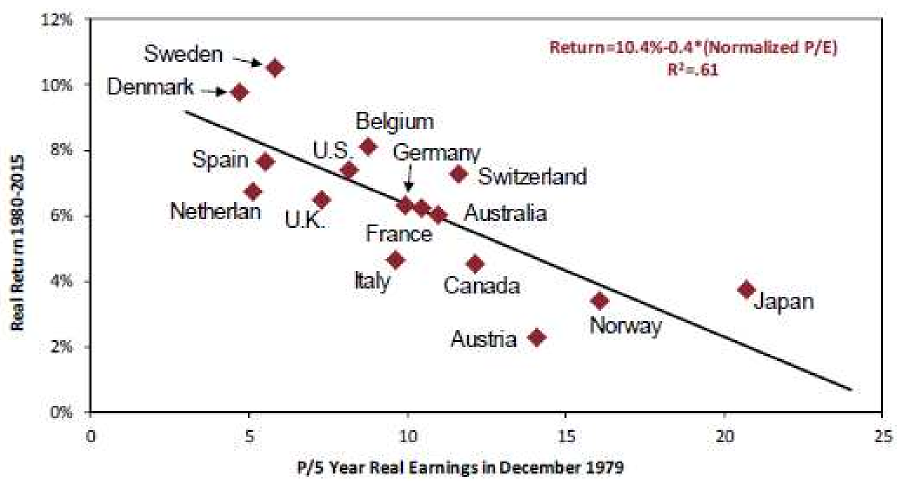
As professional investors, we are less interested in knowing which countries have the best economic growth prospects and more interested in which ones offer the best prospects for making money. One might be tempted to assume that countries with the best economic growth prospects provide the best investment returns. However, that is not true. The chart below plots the performance of various stock markets (vertical axis) versus their respective countries' economic growth rate (horizontal axis).

The plot points are widespread indicating there is little correlation between economic growth and stock returns. To the extent there is a modest correlation, it is negative implying that high growth countries' stock markets have actually slightly underperformed low growth countries' stock markets.



Source: GMO, Datastream, MSCI; Data from 1980-2015
Excerpted from GMO Quarterly Letter, First Quarter 2016

The question one should ask next is "if future economic growth is not a useful criterion for identifying high performing stock markets, then what is." The answer is simple. Inexpensive valuation is a good indicator of strong future stock market returns. In the chart below, the horizontal axis shows price-to-earnings ratio for various countries at the beginning of 1980. A small number implies stocks are cheap and vice versa. The vertical axis shows subsequent performance over the next 35 years. It is obvious from this chart that countries that started with cheap valuation (e.g., Denmark and Sweden) provided the best returns and those that started with high valuation (e.g., Japan) provided the worst returns.



Source: GMO, Datastream, MSCI; Data from 1980-2015

Excerpted from GMO Quarterly Letter, First Quarter 2016

These data confirm what informed investors have always known, i.e., value investing works well over the long run. However, we also know that over short-to-intermediate time periods spanning a few years, it is quite possible for value investing to underperform the broad market. One such notable time period in the United States was from 2011 to 2015. During this five year span, value investing underperformed the S&P 500 Index by 5.8% per year, quite an extraordinary shortfall.[1]

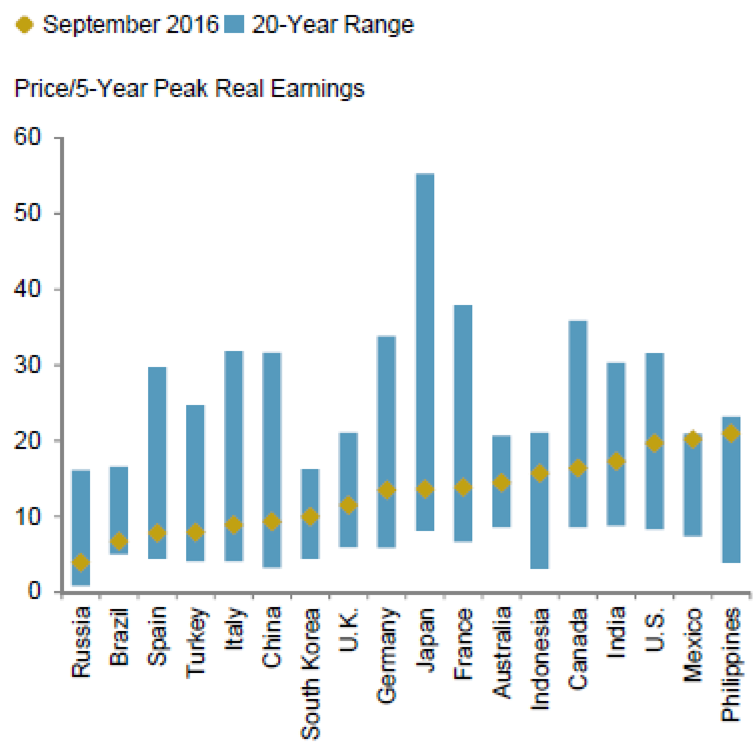
However, to quote Bob Dylan, our newest Nobel laureate as of this morning, "the times they are a changin'." Cheap stocks (e.g., in Technology and Industrial sectors) are beginning to do well and expensive stocks (e.g., in Consumer Staples and Utilities sectors) are underperforming. If the third quarter of 2016 is any indication, the dark clouds might be lifting for the value style of investing.

In light of the long-term efficacy of value investing and our belief that the tide is beginning to turn towards value investing, it is worth asking where things currently stand in terms of stock market valuations around the world. The chart on the next page shows the relevant data.

[1] *Source: Merrill Lynch, Equity and Quant Strategy Update, April 5, 2016. Value investing is based on low price to book ratio and momentum investing is based on last 12 month price return.*

The yellow markers show current price-to-earnings ratios for various countries. The blue bars represent historical ranges of price-to-earnings ratios for each country over the last 20 years. Our reading of this chart is that valuations in most foreign countries are cheap not only relative to the United States but also relative to their own 20-year histories as well. One caveat should be borne in mind though. Cheap countries are also likely to be riskier. For example, the two cheapest countries, Russia and Brazil, have their unique sets of risks that are higher than those of developed countries. Therefore, investing via broadly diversified investment vehicles is the logical course for most investors.

Country by Country Valuations
Current Levels vs. Historical Ranges



Source: Fidelity Quarterly Market Update, Fourth Quarter 2016

The re-emergence of value investing benefitted our portfolios significantly during the third quarter. We are planning to maintain the course because we believe that the value style of investing will outperform the broad market over the next few years.

Investment Returns

All four products outperformed their respective benchmarks during the third quarter. Their returns 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, 2016

	One Quarter	One Year	Five Years	Since Inception[2]
Large Cap Value	10.4%	17.0%	16.5%	9.6%
Russell 1000 Value Index	3.5%	16.2%	16.2%	6.8%
Large Cap Growth	8.6%	11.8%	15.1%	8.3%
Russell 1000 Growth Index	4.6%	13.8%	16.6%	3.9%
International Equity	7.7%	5.7%	6.9%	1.7%
MSCI AC World ex US Index[3]	6.9%	9.3%	6.1%	1.3%
Global Opportunity	8.6%	10.0%	n/a	3.3%
MSCI AC World Index	5.3%	12.0%	n/a	5.2%

[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; 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

In our last quarter's letter to clients we said:

> *"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."*

This positioning worked well during the third quarter and we made only modest changes to the portfolio as described below.

Large Cap Value

High Pointe's Large Cap Value strategy produced a return of 10.4% for the quarter, beating its benchmark, the Russell 1000 Value Index by 7.1%. Sector positioning was on the mark as the sectors we underweighted because of their expensiveness (e.g., Utilities and Consumer Staples) had negative returns. By contrast, sectors we overweighted because they were cheap (e.g., Technology, Industrials and Consumer Discretionary) performed well.

At the individual stock level, our patience with our casino and semiconductor industry investments paid off. Many other investments in old-fashioned technology stocks performed well as did a biotech investment. One of the few blemishes was a banking investment which found itself in the headlines for the wrong reasons. We believe the headlines effect will wear off over the long run and are maintaining our investment.

During the quarter, we eliminated our hospital industry investments as well as reduced our exposure to the automotive industry in light of weak secular industry trends and to reduce exposure to leveraged balance sheets. We realized gains in some of our technology investments and deployed the proceeds in selected industrial stocks that have yet to participate in the recent uptrend in cyclical stocks.

Large Cap Growth

High Pointe's Large Cap Growth strategy produced a return of 8.6%, outperforming its benchmark, the Russell 1000 Growth Index, by 4.0%. An overweighting of consumer discretionary stocks and underweighting of consumer staples stocks added value. However, most the value added came from stock selection because sector bets were fairly modest.

In the consumer discretionary sector, our investment in luxury retail, motorcycles and casino industry rebounded smartly from their relatively low valuation levels. The old-line technology stocks we hold in our portfolio also performed well as investors were gravitating to them from other more expensive sectors. Our lone financial sector investment also performed well as interest rates finally showed some signs of rising.

During the quarter we made very little changes to our portfolio. We sold a pharmaceutical company to lock in gains and a technology company that was acquired.

International Equity

High Pointe's International Equity strategy produced a return of 7.7%, outperforming its benchmark, the MSCI All Country World ex-US Index, by 0.8%. Most of the value added came from stock selection as sector bets were rather modest.

Cyclical stocks in industrial and commodities industries performed particularly well whereas stable stocks in the pharmaceutical and food industries lagged. Financial stocks in particular were strong performers once Brexit induced concerns faded.

During the quarter, we repositioned our Japanese holdings by realizing gains in a housing exposed investment that had performed well and another in the electronics industry that had lagged our expectations and achieved only modest gains. We also booked gains in a European industrial stock where the path forwarded seemed clouded because of weak global growth. Proceeds were invested in liquor and telecom industries.

Global Opportunity

High Pointe's Global Opportunity strategy produced a return of 8.6%, beating its benchmark, the MSCI All Country World Index by 3.3%. Most of the value added came from stock selection as sector bets were rather modest.

In the United States old-line technology stocks performed particularly well. Outside the United States performance was led by commodity-oriented stocks.

During the quarter, we only made one change to the portfolio and sold a pharmaceutical company as it faced the likelihood of increased competition.

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We are pleased with recent performance. Although we plan to maintain the value focus of our strategy, we are beginning to explore opportunities in selected consumer staples stocks that have underperformed in the recent run up in the market. We look forward to reporting and discussing our full year results with you in January. Thank you for your continuing trust and confidence!