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Innovate. Deliver.

HighPointe

In the Room Where It Happens

I rarely read books twice. Until recently, there were only two such books – *The Adventures of Huckleberry Finn* and *Shogun*. Now, I can add a third one to the list. It is *The End of Alchemy* written by Mervyn King, the former Governor of Bank of England. He presided over the British central bank for ten years ending in 2013. In this role, he had a seat at the table of world leaders trying to save our financial system during the 2007-2008 crisis. (To use the new vernacular inspired by the Broadway play Hamilton, he was "in the room where it happened.")

Merriam-Webster defines alchemy as "power or process that changes or transforms something in a mysterious or impressive way." King uses the term to refer to the power of our banks to create money out of nothing but the trust of their depositors. This is how it works.

You deposit $100 in your bank. The bank keeps a fraction, say 10% or $10, in reserve and lends out $90 to a business. The business pays out $90 to various vendors who deposit it in their bank accounts. The bank keeps 10%, i.e. $9, in reserves and lends $81 in loans to another business.

As this process repeats itself many times, we can get to a point where depositors in aggregate believe that they have $900 in ready cash ("money") at the bank. In reality, the bank only has $100 in cash to pay the depositors at short notice. The other $800 is "perceived money" and a result of alchemy. Of course, the bank has not lost $800, but it is tied up in illiquid loans and not available to meet depositors' redemption requests, should there be a run on the bank.

For many years, banks took increasing liberties with their power to "create money". They leveraged their balance sheets by borrowing short term funds and investing them in less liquid or risky assets. This mismatch produced substantial profits but then reality hit home in 2007. Declining home prices laid bare the thin safety margin with which banks were operating. Their capital evaporated and many of them were on the verge of bankruptcy when the government and central banks bailed them out by putting up taxpayers' wherewithal as collateral.

It was hoped and expected that after the near-death experience in 2007-2008, banks would be made much safer for depositors. King argues that this has not happened. He writes, *"The strange thing is that after arguably the biggest financial crisis in history nothing much has really changed in terms either of the fundamental structure of banking or the reliance on central banks to restore macroeconomic prosperity."* King believes there is a need to fundamentally separate the banks' roles of taking deposits and facilitating payments from that of higher risk activities such as trading and investing in illiquid or esoteric assets.

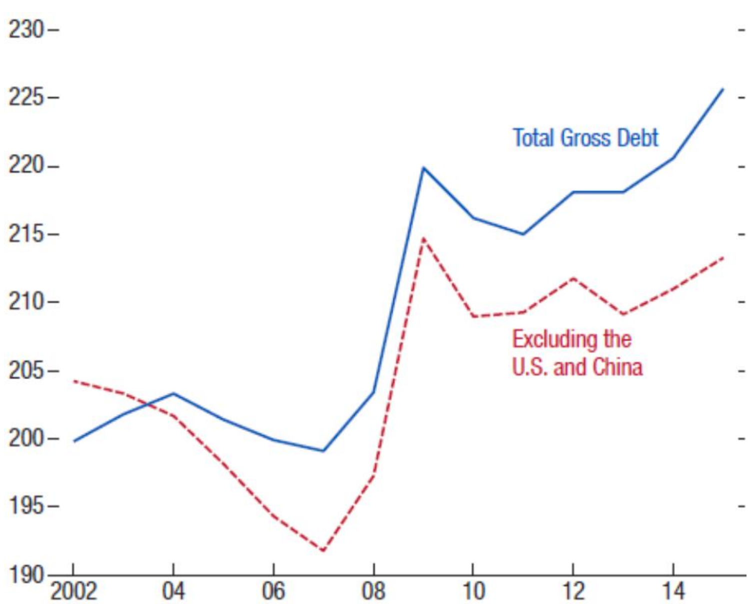
So, have banks become safer since the financial crisis? And, are they safe enough?

The first question is easier to answer but there is room for doubt on the second one. U.S. banks have become safer in that they have improved their capital position and that would allow them to absorb bigger losses than they could last time. There is disagreement among experts, however, whether they are safe enough. Just last week, the President of the Federal Reserve Bank of Minneapolis Neel Kashkari took Jamie Dimon, CEO of J.P. Morgan Chase, to task in a blunt blogpost. Dimon, in his shareholder letter had written "*essentially, Too Big to Fail has been solved — taxpayers will not pay if a bank fails.*" Dimon went on to say that "*it is clear that the banks have too much capital.*" Kashkari called Dimon's claims "*demonstrably false*" and went on to add that in his opinion banks' current capital levels (about 11% of assets) are half of where they ought to be.

Authorities around the world have been making occasional but subdued announcements that in the next financial crisis governments and taxpayers will not bail out banks, their shareholders, their creditors and their depositors. Whether they will have the temerity to follow through on these announcements is untested.

King's second point that there has been an excessive reliance on central banks to restore macroeconomic prosperity is unquestionably true and is widely accepted. Central banks have taken interest rates to abnormally low levels, and have gone even to the point of engineering negative interest rates which is a historical first. This has caused global debt levels to not only re-trace the level that existed just prior to the financial crisis, but actually exceed it as shown below.

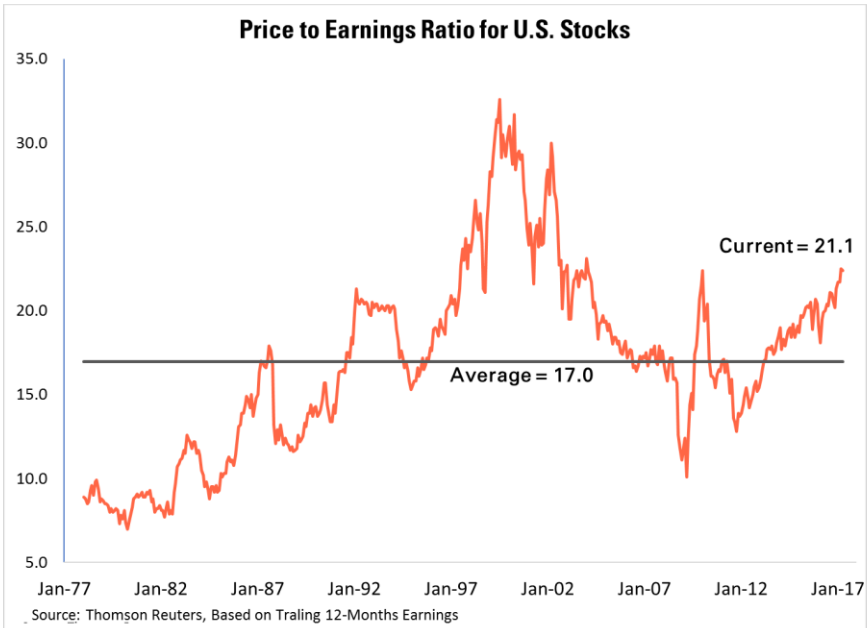
Global Gross Debt as a Percent of GDP



Sources: Abbas and others 2010; Bank for International Settlements; Dealogic; IMF, *International Financial Statistics*; IMF, Standardized Reporting Forms; IMF, *World Economic Outlook*; Organisation for Economic Co-operation and Development; and IMF staff estimates.

Exercpted from IMF Publication *Debt: Use it Wisely*, October 2016

Artificially low interest rates have propelled the equity markets, resulting in current S&P 500 valuations higher than pre-financial-crisis levels as shown in the graph below.



King's arguments resonate with us at High Pointe. We are well aware of the distortions and imbalances in the global economy caused by the actions of governments and central banks. As a result, it is our view that risks in capital markets are higher than normal, deserve extra scrutiny and perhaps more moderate risk taking. Here are some of the ways we are judiciously managing risks in our portfolios while continuing to participate on the upside.

Within equities, we are:

- Paying increased attention to debt on the balance sheets of companies we buy and maintaining a below-average debt-to-equity ratio at the portfolio level.
- Other things being equal, favoring companies with stable rather than cyclical businesses.
- Monitoring markets for stress points and taking action as needed. For example, we have reduced our exposure to the automotive segment as signs of stress in the auto loan market have become evident.
- Favoring stocks with lower valuations but not compromising quality at the aggregate portfolio level in the process.

Within balanced accounts, we are minimizing exposure to junk bonds in the United States where there is not enough reward for the risk. We also believe that for individual investors some exposure to hard assets such as gold is appropriate.

Another financial crisis, by definition, would cause damage to investment portfolios by the time authorities get together in the room to mitigate the crisis. Our goal is to navigate effectively through such times regardless of what happens in the room where it happens.

Gautam Dhingra and Chris Olson
April 11, 2017

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 March 31, 2017

	One Quarter	One Year	Five Years	Since Inception[2]
Large Cap Value	3.6%	23.8%	14.0%	10.0%
Russell 1000 Value Index	3.3%	19.2%	13.1%	7.2%
Large Cap Growth	8.2%	18.4%	11.4%	8.7%
Russell 1000 Growth Index	8.9%	15.8%	13.3%	4.4%
International Equity	8.7%	12.1%	4.3%	2.3%
MSCI AC World ex US Index[3]	7.9%	13.1%	4.4%	1.8%
Global Opportunity	6.3%	17.1%	n/a	5.2%
MSCI AC World Index	6.9%	15.0%	n/a	6.8%

[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 47 countries (23 developed and 24emerging 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 48 countries (24 developed and 24emerging 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 generated a return of 3.6% for the quarter, outperforming its benchmark, the Russell 1000 Value Index, by 0.3%. Strong returns were seen in the Technology and Healthcare sectors while the volatile Energy and defensive Consumer Staples and Telecommunications sectors were weak.

During the first quarter, we reduced our cyclical exposure in stocks with significant financial leverage in Energy, Consumer Discretionary and Industrials sectors in favor of other cyclicals with lower debt levels and more stable business models. We also replaced one Healthcare holding that had reached our price target with another that became attractive due to temporary setbacks.

Large Cap Growth
High Pointe's Large Cap Growth strategy produced a return of 8.2% for the quarter, trailing its benchmark, the Russell 1000 Growth Index, by 0.7%. The Technology and Healthcare sectors were the standout performers within the strategy with very robust returns while Industrials saw more modest returns.

Our portfolio remained essentially unchanged as we continue to like what we already own. The only change was that we sold one media holding in the Consumer Discretionary sector after a recent run of strong performance.

International Equity
High Pointe's International Equity strategy produced a return of 8.7% during the quarter, exceeding its benchmark, the MSCI All Country World ex-US Index, by 0.8%. Stocks were strong across the board in most countries, particularly Emerging Markets which saw a number of strong, double-digit returns.

Our portfolio benefitted from the launch of a takeover bid in one of our Materials holdings and Financials stocks, with the exception of Japanese Financials, continued a recovery that developed in the second half of last year. Our Energy holdings remained subdued due to weaker oil prices.

During the quarter, we increased our investments in the Technology, specifically Taiwanese Technology, and Materials sectors. We decreased our investments in the Consumer Discretionary sector, exiting a holding that is exposed to the slowing auto industry, as well as the Industrials sector where we sold out of a stock tied to European trucking. Both reductions helped lower the portfolio's leverage level.

Global Opportunity
High Pointe's Global Opportunity strategy produced a return of 6.3% for the quarter, trailing its benchmark, the MSCI All Country World Index, by 0.6%. Returns for the strategy were led by international stocks though US stocks also, by and large, exhibited positive returns.

Among sectors, US and International Technology were strong performers as were Emerging Market stocks across the board. Energy, not surprisingly, lagged and a Consumer Discretionary stock related to the grocery sector saw negative returns on the back of continued pricing pressures in the industry. We exited one media name in the Consumer Discretionary sector after a recent run of strong performance.

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Thank you for entrusting us with the responsibility to manage your investments. We look forward to reporting our progress to you again in July 2017.