NorthPointe Capital
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1Q 2018 Northpointe Capital Micro Cap Value Commentary

General Market Commentary for 1Q18

The 1st quarter of 2018 was a tale of two separate and distinct markets. The first half was characterized as the continuation of the growth, momentum and "up and to the right" trade, regardless of the underlying fundamentals. The second half was characterized by what we have been warning about for several quarters now, and that was the dramatic unwinding of what we have termed "the second largest crowded trade" in market history. Early results in April suggest this trend is continuing.

As we had discussed with investors at the end of 2017 and into early 2018, the market, in our view, was exhibiting irrational behavior. In the first month of 2018, "growth" outperformed "value" by a wide margin continuing a trend that has been in place for nearly a decade now even though a majority of "growth" stocks in the Russell Microcap® Index are still not earning any current income. The only logical argument for growth stocks is that all current equity valuations are dependent on future earnings, sometimes several years or more into the future. As such, growth stocks are long duration assets and most sensitive to discount rate changes. It is reasonable to expect therefore, since all rates on the curve have risen in the last six months, that long duration assets will eventually see the largest price declines. We began to see signs of this decline in March as one of the higher momentum sectors in the Micro Cap Index, Biotech, declined 12% from their intra-quarter high. Yet, the stronger returns from growth stocks early in the quarter carried the Russell Micro Cap Growth with a return of 1.01% vs. .37% for the Micro Cap Value Index for the full quarter.

Portfolio Commentary

Consistent with the overall market, your portfolio had a nice recovery in the second half of the quarter, yet, for the quarter ending March 30, 2018, the NorthPointe Micro Cap Value composite lost 3.51% while the Russell Micro Cap® Index gained .64% respectively. The entire underperformance for the quarter came in the first half growth/momentum market, however once the big move in the volatility as measured by the VIX settled down, the portfolio finished strong for the quarter with a 2.49% return in March vs. a 1.44% return for the index. Stock selection was the primary contributor to underperformance. In the Bitoech/Pharma area, our underweight and stock selection did not keep pace with the outsized move in the group. As an example, our holding in Gemphire (GEMP) was down 18% on the completion of a secondary stock offering which gives the company ample capital for the next few years. We believe GEMP, with substantial Phase I and II data, and meaningful catalysts as we move into the rest of the year, has enormous upside potential with a valuation target 200+% higher. In addition, we had one financial stock, Atlas

Financial (AFH) that reported a disappointing reserve charge for the fourth quarter, that led to 114 bps of underperformance in the quarter. However, the company, considered to be one of the best managed specialty insurers, and a likely takeover target after the stock drop, reaffirmed that they will earn more than $2.00 per share for 2018, making it one of the cheapest stocks in the entire sector. We have reviewed the causes of the shortfall and believe they are very temporary in nature. Finally, our technology stocks failed to keep pace with the momentum-driven sector as we continued to transition out of old names and into better-positioned stocks. In particular, Synacor (SYNC) continued to perform poorly through the quarter as we were exiting the stock. On a positive note, larger legacy positions that we have re-underwritten such as Carbonite (CARB) performed well, returning close to 15% in the quarter.

The largest positive contribution to performance in the first quarter came in the energy area, as our stocks, led by a big move in Mammoth Energy, were up approximately 10.61% for the quarter vs. the overall Energy sector, which returned -8.28%. In addition, seven new names added to the portfolio, sponsored by our new team member Bryan Franco performed well, led by Macrogenix (MGNX) and Enphase Energy (ENPH) which collectively adding approximately +77 bps in stock selection. Other new names to the portfolio, such as Addus Healthcare (ADUS), up 23%, and CitiTrends (CTRN), up 39% added approximately +121 bps to performance. Finally, we have begun to see a turnaround in last year's underperformers, such as Flotek (FTK), Meta Financial (CASH) and Neophotonics (NPTN), which returned 30%, 18% and 5% respectively for the quarter. Underperforming names that continued to have fundamental challenges in the first quarter such as Horizon Global (HZN) were sold to make room for better positioned companies and stocks.

With the recent sell-off of certain growth/momentum sectors, there are multiple signs that a shift is taking place among investors. The stocks that were last year's underperformers have established new uptrends while last year's winners look to be in topping formations. It's always a give and take in these shifts, but like the crowded "Nifty Fifty" stocks in the early 1970's, when the valuations became excessive, these darlings gave way to big relative move in small-cap, and under-owned stocks. We think a similar move is underway, and believe the portfolio has tremendous alpha upside looking forward. We also continue to find very compelling new investment ideas. As always, we strive to maintain a disciplined view of each investment in your portfolio, understanding why we have confidence in the company and why we own the stock without being influenced by the day to day change in the stock price. As such, our research efforts remain the same. Our investment process remains the same

Team

Over the past 25 years, I have used challenging periods to carefully reflect on our team and how we allocate resources with a critical eye on investment talent. As we discussed at the beginning of the quarter, our addition of Bryan Franco to the team has been a very positive development. He has already added value in the portfolio, and as his influence will increase throughout the year. As we look at the portfolio from a characteristic perspective, the portfolio has rarely looked better over the micro cap's ten-year track record, bolstered by new names and names that are recovering strongly.

As always, I am available to meet with you in person or over the phone to discuss the portfolio, the market shifts and our commitment to an improved client experience.

Sincerely yours,

Jeffrey C. Petherick, CFA
Partner

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The Russell Micro Cap® Index measures the performance of the micro-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.