1Q18 SCV Commentary

General Market Commentary for 1Q18

The 1st quarter of 2018 was a tale of two 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 an initial unwinding of what we have termed "the second largest crowded trade" in market history. Early results in April suggest this trend is continuing.

The steady climb for stocks witnessed throughout 2017 continued during the first several weeks of 2018. The global economic recovery was well underway, and investors had grown accustomed to the gradual move higher in the broad market indices. This calm came to a crashing halt as January ended. Inflation fears were blamed for the dramatic correction that ensued during the first week of February. Investors faced a week in which the Dow Jones Industrial Average fell more than 1,000 points on two separate trading sessions. Volatility indices spiked. The calm and steady investing environment that had persisted for quite some time was over. Modest rallies, and declines, occurred during the remainder of the quarter. Toward the end of March, market declines were attributed to fears of a trade war between the United States and China as the presidents of both nations threatened to impose tariffs.

Both small and large cap stocks were marginally lower for the first quarter of 2018 with the Russell 2000® Index declining .08% and the Russell 1000® Index declining .69%. The momentum that continued into the new year carried growth stocks for the quarter as they outperformed value stocks with the Russell 2000® Growth Index returning 2.3% while the Russell 2000® Value Index lost 2.6. The Growth Index fared better than its value counterpart due to much higher exposure to the outperforming Information Technology and Health Care sectors. Indeed, these two sectors comprise nearly 50% of the Russell 2000® Growth Index while only representing approximately 15% of the Russell 2000® Value Index.

Portfolio Commentary

For the quarter ending March 31, 2018, the NorthPointe Capital Small Cap Value composite outperformed the Russell 2000® Value Index. The Small Cap Value gross composite return was -.64% vs -2.64% for the Russell the Russell 2000® Value Index. The outperformance was driven by stock selection, primarily in the Energy, Materials and Information Technology sectors. The stock of Mammoth Energy Services, Inc. performed well and was the largest positive contributor to the portfolio's performance during the quarter. Mammoth, a provider of oilfield services, delivered earnings above expectations due to work obtained from a new infrastructure unit. The Company was awarded nearly $1 billion in contracts to rebuild the utility infrastructure in Puerto Rico. Within the Materials sector, the stock of Flute Industries, Inc. was also a strong contributor.

Another strong performer was Flotek, a specialty chemicals company that provides drilling fluid to the oil & gas exploration industry and a name we maintained in the portfolio throughout 2017. After bottoming in the second half of 2017, the stock started to recover in the first quarter of 2018 due to a better earnings profile and an increase in the price of crude oil. The portfolio's investment in Cypress Semiconductor Corp. performed well as the Company reported better than expected earnings and provided strong forward guidance. As the name implies, Cypress Semiconductor a company that designs semiconductors primarily for the communications industry benefited from the proliferation of the "Internet of Things" where many objects, machines and systems are interconnected.

Other highlights during the quarter include the continued recovery in the stock of Meta Financial Group, Inc., a provider of banking and payment services. In mid-2017, the stock declined when the Company did not renew a loan agreement with a national income tax preparation service provider. At the time, we maintained that investors had overreacted to the announcement and stayed with the investment. And the portfolio was rewarded when the stock fully recovered by the end of the year. The stock has gotten off to a strong start in 2018 as the Company has reported solid earnings and completed transformational (and accretive) acquisition. Additionally, the stock of Supernus Pharmaceuticals, Inc., a long time top holding of the portfolio, had a strong quarter as the Company continues to experience robust growth of its marketed drug portfolio and nears clinical data read outs of its future drug programs.

The single largest detractor to performance during the quarter was the decline in the stock of Horizon Global Corp. Horizon is a global leader of towing accessories and has taken advantage of international opportunities to expand its presence and scale. However, it appears these deals diverted attention away from the core domestic business as several issues arose in sales processing and distribution. We had believed such issues were temporary. We were wrong. As we do not have visibility on when, or how, such issues will be remedied, we exited our position in Horizon. The portfolio's investment in YRC Worldwide, Inc. was also a disappointment. YRC is a national provider of less-than-truckload shipping services and has been in turnaround mode for several years. Since we initiated the position in the spring of 2017, the stock nearly doubled due to the vastly improved shipping environment. We took some profits in the position but did not completely exit. The stock suffered as the Company reported solid revenues, but profitability declined as they were forced to purchase high-cost trucking capacity as they did not have the in-house capability to meet demand. The trucking environment remains strong, perhaps the strongest in years, but we remain on watch to see if the cost situation improves.

A detailed review of the portfolio during this volatile period suggest individual stock performance and differentiation drove the performance and not the macro factors that were prevalent in 2017. Monthly, the portfolio outperformed the market in two of the three months in the first quarter of 2018. While the portfolio underperformed in January, the monthly underperformance was entirely due to the stock of Horizon Global. This point is made to illustrate our focus is on individual companies and specific investment opportunities. We make no claim to have better insight on economic indicators, trade policy modifications or fiscal policy decisions and how investors will perceive them. We do, however, stand by the belief that focusing on undervalued stocks with identifiable catalysts will lead to attractive investment returns.

At the end of the quarter, the portfolio's three largest positions were the stocks of Cotiviti Holdings, Inc., Kelly Services Inc., and Tristate Capital Holdings, Inc. Cotiviti provides billing accuracy services to healthcare insurance companies while Kelly Services provides staffing services. Tristate Capital operates as a bank holding company in the northeast part of the United States. All three of these investments delivered positive returns, on both an absolute and relative basis, for the quarter.

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 his influence will increase throughout the year. As we look at the portfolio from a characteristic perspective, the portfolio has rarely looked better over our 23-year track history, 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 2000® Index measures the performance of the small-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 members