NorthPointe Capital®
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NorthPointe Capital
2Q15 Small Cap Value Commentary

General Market Commentary for the Second Quarter of 2015

The stock market, as measured by the broader indices, traded in a relatively narrow range during the second quarter of 2015. Despite the subdued overall price movements, there were plenty of headlines to garner investor's attention. M&A activity continued at a strong pace and much was written on topics such as when will the Federal Reserve raise interest rates, how the situation in Greece unfolds and where the price of oil is heading.

Small cap stocks marginally outperformed large caps in the second quarter as the Russell 2000® Index generated a return of .42% relative to the .11% increase in the Russell 1000® Index. Similar to the first quarter, value stocks trailed growth as the 1.98% gain in the Russell 2000® Growth Index beat the 1.19% decline in the Russell 2000® Value Index. The underperformance was a result of less exposure to Health Care (the best performing sector during the quarter). The growth index also generated better overall performance within the Information Technology sector and had minimal exposure to the underperforming Utilities sector.

Most sectors within the Russell 2000® Value Index were negative during the second quarter, with only 3 sectors generating positive performance (and 2 of the 3 positive sectors had returns less than .15%). Despite the broad based decline, the portfolio achieved a positive return. We believe this supports our approach to investing at the individual stock level. While we are aware of the national and global factors that impact the market, we take comfort that our investments have company specific catalysts on the horizon that could unlock value and are not dependent on macro-economic or geopolitical forces. As stock pickers, we don't believe we have an expertise in forecasting those latter items. We do, however, believe we can identify attractive investments based on individual company characteristics and fundamentals no matter the overall investing environment.

Portfolio Commentary

For the quarter ending June 30, 2015, the portfolio outperformed the benchmark, the Russell 2000® Value Index. The majority of the outperformance came from solid stock selection within the Health Care and Materials sectors. The portfolio's best performing stocks in the second quarter were Supernus Pharmaceuticals and Novax, Inc., with gains of approximately 40% and 35%, respectively, in the current quarter. This performance comes after the same stocks registered strong gains in the first quarter of the year as well.

Each company continues to execute on their drug development programs and in the case of Supernus, the sales of its epilepsy drugs remain strong. Also advancing within the Health Care sector was the stock of AtriCure, Inc., a developer of cardiothoracic devices. AtriCure continues to succeed in selling devices to treat irregular heart rhythms; the technical term being atrial fibrillation. The stock of Materials holdings Ferro Corporation was also a solid performer in the quarter as it advanced in excess of 30%. The Company, a provider of specialty chemicals, reported better than expected results, raised earnings guidance due to strength in the performance colors & pigments segments and announced a sizable acquisition that will increase net income.

Stock declines from the Consumer Discretionary and Energy sectors detracted from performance. The investment in MDC Partners, a collection of advertising agencies, suffered when the Company announced it was being investigated by the SEC for financial irregularities, most likely related to expenses incurred by its Chief Executive Officer. Due to the limited visibility we have surrounding this situation we have reduced our position in MDC. Disappointing earnings caused a decline in the stock of Harte-Hanks, Inc., a direct marketing company. Similar to MDC, we have reduced our position in Harte-Hanks. In the Energy sector, the stock of Sanchez Energy Corp. ended the quarter with a negative return. Despite a quarterly gain in the price of crude oil, which typically drives exploration stocks such as Sanchez, investors have continued to shy away from small cap Energy companies.

At the end of the first quarter, the portfolio's largest investments were in the stocks of Renasant Corp., a provider of banking and insurance services, Radian Group Inc., a provider of mortgage insurance and Aerie Pharmaceuticals, a developer of drugs to treat glaucoma and other eye ailments. All three stocks added to performance during the quarter. The story behind Aerie deserves a little more detail. The Company has a glaucoma drug in late stage development. In April, the Company reported results from a drug trial that disappointed investors causing the stock to suffer a significant decline. We remained confident in the results and the pathway for the drug to be approved and took advantage of the decline to materially increase our position. Toward the end of the quarter, the Company received positive acknowledgement from the FDA, potentially supporting our investment thesis, which ignited a strong rally in the stock. From its low point in May to its high point in June, the stock advanced in excess of 100%, highlighting the volatile nature of small cap stocks, especially within the Health Care sector.

Research Efforts

We continue to focus our research efforts on identifying companies that have specific near term catalysts whose stocks are currently being undervalued by the market. No matter the macroeconomic environment or current investor sentiment, the universe of small cap stocks is broad such that we are confident our due diligence process will continue to discover attractive investment opportunities.

For current holdings, we remain vigilant in monitoring valuation levels relative to the catalysts that have occurred, or are expected to occur, to ensure that the portfolio contains only the most attractive investments.

Sector or Industry Shifts

The portfolio's investments in the Health Care sector remained the largest overweight exposure relative to the Russell 2000® Value Index. The portfolio also maintained a notable overweight position to the Information Technology sector throughout the quarter. The additional of several new Consumer Discretionary stocks resulted in the portfolio moving from an underweight to overweight position during the past quarter. Additionally, new investments in an industrial products distributor and specialty construction provider resulted in a near elimination of the underweight that the portfolio maintained relative to the Industrials sector. We eliminated the stocks of two chemical companies, yet still maintain an overweight position to the Materials sector. Exposure to Financials remained the largest underweight position. The portfolio continues to be underexposed to the Utilities and Consumer Staples sectors, with no investments in the latter sector. There were no other significant industry shifts