



**NorthPointe Capital, LLC**  
**Small Cap Value**  
**2<sup>nd</sup> Quarter 2016**

**General Market Commentary for the Second Quarter of 2016**

The broader market indices traded in a relatively narrow range during the first two months of the quarter. Toward the end of May, a stock market rally seemed to be gaining steam right up until “Brexit” began dominating the headlines in mid-June. Brexit is the colloquial term used for Britain’s decision whether or not to remain a member of the European Union and on June 23, 2016, the vote to exit prevailed. The initial market reaction was negative as global market exchanges fell precipitously. However, the decline was limited to two days as doubts about what Brexit actually means spurred a rally through the remaining days of the second quarter.

Small cap stocks outperformed large caps as the Russell 2000<sup>®</sup> Index recorded a quarterly gain of 3.79% relative to the 2.54% increase in the Russell 1000<sup>®</sup> Index. Value stocks fared better than growth as the 4.31% gain in the Russell 2000<sup>®</sup> Value Index surpassed the 3.24% increase in the Russell 2000<sup>®</sup> Growth Index. The outperformance was the result of greater exposure to the strong Utilities sector and better stock returns within the Financials and Materials sectors.

What exactly does the Brexit vote imply for the global economy and the broader equity markets? Frankly, we have no idea and view quite skeptically anyone who claims to have a definitive answer. Many of the portfolio holdings will not be affected. Some will and we rely on our deep understanding of the companies we invest in to approximate the potential impact. Most importantly, we did not panic when the market’s initial reaction was negative, as we have a longer term investment focus. By analyzing each individual company and ignoring the “noise” we strive to deliver attractive investment returns for our clients.

**Portfolio Commentary**

For the quarter ending June 30, 2016, the portfolio outperformed the benchmark, the Russell 2000<sup>®</sup> Value Index. The outperformance was led by stocks within the Health Care, Consumer Discretionary and Materials sectors. However, performance was solid across the board, with 13 stocks registering gains in excess of 30%, which represents nearly 1/4 of the 56 stocks held during the quarter. The portfolio had only one stock that declined in excess of 30%, but this investment gained 95% on the last day of the first quarter, so it began the second quarter from a very lofty position.

Specifically, within Health Care, the stocks of Novavax, Inc., and Supernus Pharmaceuticals had strong gains as the companies advanced their commercial and developmental programs. Likewise, the stock of Material holding Flotek Industries, Inc. was a standout performer with the stock gaining in excess of 80% during the quarter. Flotek, a developer of specialty chemicals, recovered from investor concerns that its



proprietary oil drilling products did not produce beneficial results to its customers. Recently received data illustrate the value proposition of Flotek's chemicals, dispelling the bearish arguments against the stock.

The portfolio also benefited from M&A activity. Krispy Kreme Doughnuts, Inc., a retailer of the eponymous doughnuts, and LDRH Holding Corporation, an innovator in spinal products, were both acquired at attractive premiums to the then current stock price. While some might consider a "takeout" lucky, we view these transactions as supporting our investment process of identifying value not currently recognized by the stock market. While luck might play a role in the timing of value creation - and we will certainly take all the luck that comes our way- it is our dedicated due diligence that discovers these investment opportunities. In the case of LDRH we met with management on numerous occasions, visited the corporate headquarters to meet personnel outside of senior executives and physically implanted the Company's spinal products (in a model, not a live patient!) to see for ourselves why surgeons were raving about the implants. To learn more about the transformation taking place at Krispy Kreme, we visited the Company's prototype store in North Carolina. At that location, management had implemented data analytics and made numerous changes to the selling process with the goal being to improve the customer experience and drive sales.

On the negative side, investments in Super Micro Computer, Inc. and Infinera Corporation, both within the Information Technology sector, declined as each company provided earnings guidance that was below consensus expectations. We eliminated the position in Infinera, but maintained the investment in Super Micro as we believe the Company is taking share in the server market.

At the end of the second quarter, the portfolio's largest investments were in the stocks of Supernus Pharmaceuticals, Inc. Novavax, Inc. and Flotek Industries, Inc. As previously discussed, each of these holdings was among the best performers within the portfolio during the quarter.

### **Research Efforts**

In the final days of the quarter, the stock market experienced elevated volatility. This trend may continue for some time due to uncertainty in the global macro environment. We strive to maintain a disciplined view of each investment, understanding 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.

### **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 within the Materials sector throughout the quarter. The addition of a trucking company and several diversified industrial stocks drove the relative weight within the Industrials sector from a slight underweight to an overweight position by the end of the quarter. The overweight position in the Consumer Discretionary



sector was reduced by the sale of Krispy Kreme Doughnuts. Exposure to Financials remained the largest underweight position. Additionally, the portfolio continues to be underexposed to Utilities. There were no other significant industry shifts.

*Past performance is no guarantee of future results. The value of investments may go down as well as up and investors may not get back their original investment. Performance is shown gross of fees and charges. The opinions expressed herein are those of NorthPointe Capital, LLC as of the date of this report and are subject to change at any time. Although the third party information has been obtained from and is based on sources the Firm believes to be reliable, the Firm does not guarantee the accuracy of the information, and it may be incomplete or condensed. This report is for informational purposes only, and is not intended as a recommendation with respect to the purchase or sale of any security. A list of all recommendations made within the last 12-months is available upon request. It should not be assumed that any of the securities transactions or holdings discussed will prove to be profitable, or that investment decisions or recommendations made in the future will be profitable or will equal the performance of the securities discussed herein. The securities discussed do not reflect the entire portfolio and in the aggregate may represent only a small percentage of the portfolio's holdings.*

*The Russell 2000® Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000® companies with higher price-to-value ratios and higher forecasted growth values. 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 membership. The Russell 2000® Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership*