



## 3Q10SCV Commentary

### **General Market Commentary for the Third Quarter of 2010**

The 3rd quarter's headline reads "Risk On, Risk Off, Risk On." The market averages surged in July, dropped precipitously in August, and rebounded with the strongest September since 1939. Small capitalization stocks slightly underperformed large caps as the Russell 2000<sup>®</sup> Index returned 11.29%, as compared to the 11.55% return of the large company Russell 1000<sup>®</sup> Index. Value stocks, which had substantially larger exposure to the underperforming Financials sector, underperformed growth stocks as the 9.72% gain in the Russell 2000<sup>®</sup> Value Index fell short of the 12.83% gain in the Russell 2000<sup>®</sup> Growth Index.

Throughout the quarter, macro concerns dominated investor sentiment. In our opinion the headlines are not the only story that matters. Our duty is to unearth securities where we can obtain unique insights that will ultimately lead to superior client returns. While many chose to just focus on the headlines, we have chosen to read the whole paper. By digging into the uncommon stories that few read, we seek to discover markedly undervalued investments. The current headlines tell of a macro driven market; however, we believe that this myopic view has presented diligent stock pickers with a tremendous opportunity to add value. The back pages tell stories of earnings growth exceeding expectations, strengthened balance sheets, innovation, increasing M&A activity, and attractive equity valuations. Clearly the headlines have dominated the global financial marketplace, yet our research has given us increased confidence that the way forward is to focus on individual stocks. Stocks have traded together at historic levels or to rephrase in academic speak, cross-sectional stock correlation has rarely been this high. When stocks trade together, picking individual names becomes challenging. We have begun to see evidence that suggests correlations have started to decline. As this continues, individual stock stories will move back to the front page.

Going forward we foresee the economy settling into a slow growth environment, investors focusing on earnings potential in 2011 and beyond, the Fed engaging in a second round of quantitative easing, and the agenda in Washington moving to the center after the mid-term elections. This all adds up to what we think we be a constructive 4th quarter for the US equity markets and our portfolios. As the coming months play out, we remain committed to being vigilant, nimble, and proactive.

### **Portfolio Commentary**

Despite posting positive stock selection scores for the months of August and September, the portfolio was unable to completely recover from the negative stock selection performance realized at the beginning of the quarter. During July, the portfolio suffered several stock specific disappointments and did not realize any notable offsetting stock

gains. As a result, for the quarter ending September 30, 2010, the portfolio underperformed the benchmark, the Russell 2000<sup>®</sup> Index. The underperformance was primarily due to negative stock selection within the Information Technology and Industrials sectors. The largest performance detractor within Information Technology (and within the entire portfolio) was the investment in DG Fastchannel, Inc., a provider of media distribution services to the communications industry. The Company had posted solid operating results and investors had rewarded the stock throughout the first half of 2010; however, fears of competition and nebulous commentary from management caused the stock to decline nearly 40% in one trading session. We subsequently sold our investment in DG Fastchannel as we could no longer ascertain the viability of the Company's competitive advantage. The underperformance within Industrials was primarily due to the portfolio's investment in FTI Consulting, Inc. FTI, a provider of finance, economic and litigation consulting services, lowered revenue and earnings guidance as their customer base is delaying expenditures on strategic projects until more visibility is obtained on the direction of the economy. As we remain believers in the Company's strategic positioning, we added to our investment in FTI subsequent to the decline.

The portfolio realized notable positive stock selection scores from the Financials and Materials sectors. The stock of Allied World Assurance Company Holdings, Ltd., an underwriter of casualty and specialty insurance, performed well as the Company continues to transform itself from a provider of reinsurance services to a specialty insurer where investors ascribe a higher valuation. Also within Financials, the stock of Nelnet, Inc. was a strong performer. Nelnet, a servicer of government-funded student loans, is generating impressive earnings by growing its loan portfolio. Within Materials, the investment in Allied Nevada Gold Corp. continued to benefit from the increase in the price of gold as well as favorable reserve developments at the Company's mines.

At the end of the third quarter, the portfolio's largest investments were in Golub Capital BDC, Inc., Kodiak Oil & Gas Corp. and Actuant Corp. Golub Capital, a provider of financing to middle market companies, and Actuant, a diversified manufacturer of tools and specialized motion control systems, delivered strong stock performances during the quarter, both on an absolute and relative basis. Our investment in Kodiak, an explorer of oil & gas primarily in the Bakken Shale, delivered positive returns for the quarter, but failed to match the strong gains returned by the Energy sector. We continue to believe the stock of Kodiak is significantly undervalued relative to its oil & gas reserves and opportunistically added to our position throughout the quarter.

### **Research Efforts**

Given the market's advance during the third quarter, many of our investments have achieved, or come close to, our valuation target ranges. This has caused us to review our holdings to determine which of these stocks will continue their advance and which should be harvested for gains. Additionally, we have investments that did not respond to the rise in the overall market. For these positions, we have spent additional research effort to

ensure that our investment thesis is still valid and value-unlocking catalysts will occur in the near term.

In addition to the evaluation of our current stock holdings, we continue to identify new ideas that are benefiting from a recovery in the domestic market or strong exposure to thriving emerging markets; or both. Common among nearly all of the portfolio's new investments is a Company-specific change that should lead to improved earnings potential and stock outperformance that is not entirely dependent upon the macro economic cycle.

## **Sector or Industry Shifts**

At the beginning of the quarter, the Industrials sector represented the portfolio's largest relative overweight position. However, as a result of exiting several smaller holdings and selling a large investment where our valuation range was exceeded, the exposure to the Industrials sector was reduced to an in line position by the end of the quarter. Another significant change took place within the Information Technology sector where our exposure was reduced as we sold several investments and realized notable gains. As a result, at the end of the quarter this sector represented our largest relative underweight position replacing Health Care, where we continue to have less exposure than the benchmark. The portfolio maintained its relative overweight to the Financials sector and with the decline in exposure to Industrials, the Financials sector was the portfolio's largest relative overweight position at quarter's end.

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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 membership.*