



## 3Q11 Small Cap Value Commentary

### **General Market Commentary for the Third Quarter of 2011**

Global equities sold off across the board during the third quarter of 2011. Continued weak economic data, gridlock in Washington, the United States' debt downgrade by S&P, and a major banking crisis in Europe all have served as contributing catalysts to this bear market. For the quarter, small caps underperformed as the Russell 2000® Index declined 21.87% as compared to the 14.68% decline in the large company Russell 1000® Index. Value stocks marginally outperformed growth stocks as the Russell 2000® Value Index declined 21.47% relative to the 22.25% decline in the Russell 2000® Growth Index during the third quarter.

The US equity market has now declined for five consecutive months. The level of pessimism is palpable. Fears of a double dip recession or even worse, a global depression, have entered the collective consciousness of the marketplace. While many pundits are drawing parallels with the financial crisis of 2008, we see many key distinctions. Banks are better capitalized, corporate balance sheets are stronger, and the prospects for growth remain visible. The picture we are seeing at the ground level is quite different from the one given in the papers and on television. The interaction we have had with dozens of corporate management teams suggests that business conditions remain far more robust than the headlines would lead us all to believe. Your portfolio contains securities selling at exceptional value with visible prospects for growth and profitability. It is our belief that as European leaders eventually contain their banking crisis and fear subsides, value should again be realized in the portfolio.

### **Portfolio Commentary**

For the quarter ending September 30, 2011, the portfolio underperformed the Russell 2000® Index. Strong stock selection in the Health Care, Energy and Consumer Discretionary sectors was offset by negative stock selection scores from the Industrials, Financials, and Information Technology sectors. On a net basis, the portfolio's stock selection score during the quarter was nearly breakeven, while the portfolio's sector selection score was a larger detractor as the underweight in Utilities and overweight in Energy hurt performance.

Within Health Care, the stock of Akorn, Inc. a manufacturer of generic drugs, continued to perform well as strong operating results attracted investor attention to this successful turnaround story. Also adding to performance was the acquisition of Caliper Life Sciences, a manufacturer of imaging and research equipment, by a competitor at an attractive premium. Takeover activity also benefited the portfolio's Energy holdings as Global Industries, Ltd., a provider of oil field construction services, was also acquired by a competitor at an attractive premium. The stock of Gulfport Energy Corp., an oil and gas explorer, was a solid relative outperformer in a difficult sector – the Energy sector

had the lowest return within the Russell 2000<sup>®</sup> Index during the quarter – likely due to the attractiveness of its acreage in the Utica and Niobrara shale regions. Within Consumer Discretionary, the stocks of clothing retailers Express Inc. and Hot Topic, Inc. were notable positive contributors to the portfolio's performance as the companies delivered operating results ahead of consensus expectations.

The largest detractor to performance was the individual stock decline of Imperial Holdings, Inc. Imperial, a specialty finance company that provides financing for life insurance policies, was notified late in the quarter that it is under investigation by Federal agencies. The fact that the Company was newly public (IPO in early 2011) and had limited float only served to augment the stock price decline as investors sold off the stock in the absence of additional details concerning the investigation. Also detracting from performance was a decline in Industrials holdings Enpro Industries, Inc. and General Cable Corp. Enpro, a diversified manufacturer of engineered products, was sold off by investors despite posting strong operating results. The stock of General Cable, a producer of wire and cable products, declined as the dramatic sell off in the price of copper (down over 30% from its August peak) was perceived to negatively impact the Company's future earnings. Within Information Technology, the stock of Magma Design Automation was a notable detractor to performance as the Company reported only in line operating results, breaking a multi-year streak of exceeding earnings expectations.

At the end of the third quarter, the portfolio's largest investments were in Ocwen Financial Corp., a loan servicing company, DFC Global Corp., a consumer finance company, and Spectranetics Corp., a developer of cardiovascular products. Each of these investments returned positive absolute performance and were strong outperformers on a relative basis during the quarter.

### ***Research Efforts***

Despite elevated stock correlation readings and what appears to be a complete disregard of the fundamental outlook by investors, we remain focused on identifying those companies that have solid business models that will enable them to weather any potential economic disruption. We view the overall decline in the market as an opportunity to add to existing holdings as the situation merits. We are also finding the opportunity to initiate positions in stocks that we previously viewed as fully valued but have recently been sold off to very attractive risk/reward levels. Above all, we remain consistent in our approach of seeking out attractive opportunities with near term value unlocking catalysts.

### ***Sector or Industry Shifts***

At the beginning of the quarter, the largest overweight exposure relative to the Russell 2000<sup>®</sup> Index was to the Materials and Financials sectors. At the end of the quarter, these overweight exposures remained unchanged. During the quarter, the portfolio initiated positions in two attractive Utilities stocks and, as a result, exposure to the Utilities sector went from the largest underweight position at the beginning of the quarter to a slight underweight by quarter's end. Throughout the quarter the portfolio maintained

underweight exposure to the Information Technology and Health Care sectors. The exit of a successful investment within Consumer Staples resulted in the portfolio being underweight relative to this sector at the end of the quarter as compared to an overweight position when the quarter began. There were no other notable industry shifts.

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*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*