



## 4Q10 SCV Commentary

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

The fourth quarter of 2010 generally played out along the path we had expected. Stock picking mattered and the equity markets rose. Confidence returned to the investor class as the historic November elections, a strengthening U.S. economy, and the Federal Reserve's quantitative easing provided clarity and a more calming assessment of the future. The ability to add value through stock selection became evident as stock correlations declined due to a lessening concern over global macro issues. Small capitalization stocks outperformed large caps during the fourth quarter of 2010 and for the entire year as the Russell 2000<sup>®</sup> Index returned 16.25% and 26.85%, as compared to the 11.19% and 16.1% returns of the large company Russell 1000<sup>®</sup> Index for the fourth quarter and 2010, respectively. Value stocks, which had substantially larger exposure to the underperforming Financials and Utilities sectors, underperformed growth stocks as the 15.36% and 24.5% gains in the Russell 2000<sup>®</sup> Value Index fell short of the 17.11% and 29.09% gains in the Russell 2000<sup>®</sup> Growth Index for the fourth quarter and 2010, respectively.

Our equity market outlook for 2011 is constructive, yet tempered. We foresee a positive year for the market. The continued strengthening of the U.S. economy, clarity on the macro front, and a robust M&A environment make us optimistic for an up year. Stretched near term equity valuations and the realization of how far the market has moved off the bottom tempers our view. We think it adds up to a moderately positive year for equities. From an equity perspective, we think 2011 will be remembered as the year of the stock picker. We have witnessed the relevance of stock selection in recent months and expect a powerful trend of stock specific stories to emerge. A moderate return environment is precisely the time when the ability to discriminate between winning and losing stocks is most on display. Successful strategies will be those that embrace active management with the possession of insight to find unique and uncommon ideas. We will spare no effort to be counted among the successful equity managers of 2011.

### **Portfolio Commentary**

For the quarter ending December 31, 2010, the portfolio outperformed the benchmark, the Russell 2000<sup>®</sup> Index. The outperformance was highlighted by strong contribution from the Energy, Industrials, and Consumer Staples sectors. The portfolio's investment in Kodiak Oil & Gas Corp. performed well, nearly doubling in the fourth quarter, due to continued success in the Company's exploration of its reserves in the Bakken Shale. During 2010, Kodiak's stock nearly tripled. The stock of Saint Mary Land & Exploration Company, an explorer of oil and gas, was also a strong contributor to the quarterly performance as global energy prices climbed higher. The solid performance within

Industrials was led by the stock of Wabash National Corp., a manufacturer of truck trailers. The Company has undergone a multi-year restructuring initiative and is poised to benefit from a recovery in trailer orders as transportation companies look to replace their aging fleet. Portfolio performance was also enhanced by a timely return to the stock of Polypore International, Inc., a manufacturer of complex filtration products used in battery and other medical & industrial applications. After being sold earlier in the year, at a significant gain, we reinitiated our investment when investors sold off the stock upon the Company reporting earnings that met, instead of exceeding, expectations. We chose to focus on management's commentary of needing to expand capacity to meet increasing demand for its lithium battery components and were rewarded shortly thereafter as the stock recovered to an all-time high. Within Consumer Staples, the stock of Darling International, Inc. was a standout performer for the portfolio and was also the best performing stock within the entire Consumer Staple sector for the quarter. The Company, a provider of recycling and rendering services to create food oils and related products, benefited from the continued rise in commodity prices as well as a strategic acquisition that was favorably received by many investors.

The largest detractor to performance was the negative contribution from the Financials sector. This underperformance was primarily attributable to the portfolio's investment in Kennedy-Wilson Holdings, Inc., which had a small negative return, but was a notable relative underperformer when compared to the positive return generated by the sector. Kennedy Wilson is a real estate investment and services company that came public in late 2009. Despite an experienced management team with ample capital to invest in attractive opportunities, the stock is still unknown to many investors. However, we maintain our investment as the Company continues to amass an impressive portfolio of real estate assets with the stock trading at a significant discount to our calculated fair value.

At the end of the fourth quarter, the portfolio's largest investments were in Wabash National Corp., Hercules Technology Growth Capital, Inc., and First Potomac Realty Trust. As described above, Wabash was a strong performer during the quarter. Hercules Technology provides specialty financing to early stage companies and First Potomac manages industrial and office properties primarily in the Washington D.C. metro area. While both stocks generated positive absolute returns, for the quarter they were relative underperformers. We anticipate that the fundamental outlook for both Hercules and First Potomac will continue to improve in 2011 and are comfortable with our investment positions in these securities.

## **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**

As the quarter began, the portfolio's largest overweight exposure was to the Financials and Telecommunication Services sectors while the largest underweight positions were to the Health Care and Information Technology sectors. During the quarter, we identified several attractive technology investments and at quarter's end, the portfolio had an overweight positioning to this sector. Additionally, we increased our holdings in the Materials sector to the extent that this sector represented the largest overweight position at the end of the quarter. Several of our Health Care holdings, Clariant, Inc. and Martek Biosciences Corp., were acquired at significant premiums and subsequently sold from the portfolio. As a result our underweight position relative to the Health Care sector increased and remained the portfolio's largest underweight exposure at the end of the quarter.

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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.*