



NorthPointe Capital, LLC
Small Cap Value
2016 and 4Q16

General Market Commentary for 2016

The investing environment in 2016 was anything but boring. The year witnessed perhaps two of the largest political surprises in recent memory, with Britain voting to leave the European Union in June and the election of Donald Trump as President of the United States in November. Each event was contrary to the general expectation at the time and each event, however briefly, had an unforeseen impact on the broader stock market indices.

After quite a weak start to the year brought on by concerns of a global slow down, the overall markets were marginally positive leading up to the U.S. presidential election. The surprise victory of the Republican candidate sparked a nearly 20% rally in the markets through the end of the year.

Small cap stocks continued to outperform large caps as the Russell 2000® Index posted gains of 8.83% and 21.31% for the fourth quarter and full year, respectively, compared to the 3.83% and 12.05% respective returns of the Russell 1000® Index. Value stocks dominated growth stocks as the Russell 2000® Value Index returned 14.07% and 31.74% for the fourth quarter and full year, respectively, while the Russell 2000® Growth Index had gains of 3.57% and 11.32%, respectively. Value outperformed due to a greater exposure to the Financials sector, where the prospect of higher interest rates pushed these stocks higher. Additionally, the value index had less exposure to the underperforming Health Care sector.

As we have repeatedly seen with strong market rallies, the lowest quality stocks tend to move the most. In the very short term. These euphoric moves do not last and over our long investing history, we have found that stocks with improving fundamentals tend to outperform over times frames that are not measured in days or weeks. We have been here before. We have not and will not chase the euphoria. If we are truly at an inflection point and the market is about to embark on a significant move higher, we will see it in the fundamentals. We will continue to strive to find those individual stocks that are positioned to move higher because of these improving fundamentals. This is our investment process and we believe this is what works over the long term.

Portfolio Commentary

For the year ending December 31, 2016, the NorthPointe Capital Small Cap Value composite gained 20.64%, while the Russell 2000® Index and Russell 2000® Value Index gained 21.31% and 31.74%, respectively. The portfolio had an unusually challenging fourth quarter with a composite return of 5.36%, relative to the 8.83% and 14.07% returns for the Russell 2000® Index and Russell 2000® Value Index, respectively.



The underperformance resulted from negative stock selection across numerous sectors, including Information Technology, Health Care and Materials. In the Technology sector, despite a strong outlook for optical components, the stock of Neophotonics Corporation declined as the Company was unable to meet customer demand due to manufacturing problems at one of their fabrication facilities. We have maintained our investment in Neophotonics as we believe the Company will correct the manufacturing issues and can take advantage of a strong global demand for their products.

The worst performing stock in the portfolio was a Health Care holding, Adeptus Health, Inc. Adeptus operates free standing emergency room clinics, many in partnership with the local dominant hospital system. We followed the Company since its IPO in 2014 as we believed the Company addressed a continuing problem in health care - inadequate emergency room treatment. In the two years post IPO, we found the stock to be expensive; however, after the stock had retreated to a more reasonable valuation, we intensified our due diligence efforts. While the Company did face billing/collection issues, we determined the risk reward to be in our favor. Regrettably, we failed to appreciate how poorly this management team would manage its capital when faced with strong growth opportunities. We could not have been more wrong. We failed to appreciate how poorly a management team could manage its capital when faced with strong growth opportunities. In short, the management team at Adeptus allowed the Company to expand too quickly and surprisingly put themselves in a liquidity crisis. The stock was punished when this financing "emergency" was announced. Accordingly, the CFO, COO and CEO were removed from their responsibilities. While we believe the Company still has a viable, attractive business opportunity, we exited the investment until we gain confidence that there is a management team in place that can execute the plan properly. We consider our due diligence efforts to be extensive and effective, yet we missed this one. The takeaways from this investment will improve our research efforts going forward.

Also detracting from performance was the decline in the stock of Flotek Industries, Inc., a maker of specialty chemicals. Flotek's chemicals are utilized by oil and gas explorers to increase the output yield of their wells. The stock came under pressure in December due to a critical report that called into question the effectiveness of the Company's products. Our research into this issue runs counter to the criticism alleged in the report and we have opportunistically increased our investment in Flotek.

Contrary to our prime objective to outperform, not all stocks go up, particularly when measured over a 90-day period. This most recent quarter was difficult in two respects. We experienced an unusual number of adverse stock-specific events, while realizing less than our normal number of positive events. This anomaly is best illustrated when you consider that our best performer in the quarter, Headwaters did not offset our 6th worst performer. Over our investment history, the positives typically outweigh the negatives. We look forward to better and more typical outcomes going forward.



Research Efforts

We continually evaluate the portfolio to ensure that the only the most promising investments are held. In strong market rallies, such as what we witnessed toward the end of the year, certain stock moves higher are merited, while others are not. We prefer not to “chase the tape”. We maintain our focus on company specific stories where we believe the fundamental outlook has improved or is underappreciated. This has been, and will continue to be, where we spend our research efforts.

Sector or Industry Shifts

There were no significant sector shifts during the quarter. 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 and an underweight position relative to the Financials and Real Estate sectors. Additionally, the portfolio continues to have no investments in the Utilities sector.

Firm News

We have some exciting developments to share with you on matters pertaining to our firm, NorthPointe Capital. 2016 was not just a year of growth in our firm by way of assets, we added a new team member to our NorthPointe family. Lance Johnson was brought on board to bolster our distribution capabilities in Independent Financial Advisor channel and to manage the sales efforts of our NorthPointe branded mutual funds. Along these lines, we are excited about the prospects of Mike Hayden, our CEO, launching an independent third party marketing firm that will bring our investment offerings to a larger audience. From a personnel perspective, Jon Ahwal, our equity trader, passed the CFA Level 1 exam. We are proud of our commitment to professional excellence. Currently, seven members of our team are CFA Charterholders. Finally, John Pearce, our Director of Quantitative Research, is doing his part to help grow the NorthPointe Family. John and his wife, Tara, are expecting their first child this spring!

We wish you all the best in 2017!

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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