NorthPointe Capital
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2Q18 Micro Cap Value Commentary

General Market Commentary for 2Q18

Most broad stock market indices registered gains during the second quarter of 2018. Despite ongoing concerns of tariffs and global trade wars, stocks trended higher without the volatility experienced earlier in the year. Perhaps the fear of trade turbulence or the rising US dollar were behind the drive that pushed the Russell Micro Cap® Index to an all-time high before pulling back in the final days of the quarter. Large cap stocks are generally considered to have more international exposure, so it appears investors gravitated to more domestic-focused small/micro cap stocks as overseas concerns arose.

During the second quarter of 2018, Micro Cap stocks gained in investor interest, outperforming large cap stocks with the Russell Micro Cap® Index gaining 9.90% relative to the 3.57% gain in the Russell 1000® Index. The best absolute returns came from the Energy, Telecomm Services, Technology and Real Estate sectors of the index. A deeper look at what worked during the quarter indicates that valuation across the board was ignored. Stocks with higher P/E ratios did better than those with lower ratios. And what about stocks with no P/E ratio, implying no earnings at all? They were the best performers of the quarter, returning more than 3x the return seen by the stocks in the lowest P/E quintile. We have invested in environments like this before and our experience has shown these periods tend to be short lived. We do consider valuation in selecting investments for the portfolio. It is a large component of our investment process. We continue to believe that the selecting undervalued stocks with identifiable catalysts will lead to attractive investment returns.

Successful value investors take positions that the crowd will not. They do not seek to win popularity contests. Value investing demands independence of thought and steadiness of hand in face of challenge. We are following our investment process by continuing to hold these two value stocks. Our process protects against emotional overreactions and keeps our focus on making the sound investment decision. It often is not easy being a value investor and at times it can be downright painful. History has demonstrated that the temporary pain is worth the value that ultimately gets realized

Portfolio Commentary

For the quarter ending June 30, 2018, the NorthPointe Capital Micro Cap composite portfolio underperformed the Russell Micro Cap® Index, returning a gross return of 6.67% vs. 9.90% for the index. The good news was the absolute return was strongly positive for the quarter as Micro cap stocks provided some of the best returns. The tougher news is that the seemingly high infatuation with growth and momentum factors continues to drive the index higher as the index itself has taken on even more growth characteristics. On a relative basis, the portfolio was hurt by negative stock selection in the Industrials and Materials sectors as well as being overweight these two sectors. The "tariff and trade wars" discussion in the investment community moved stocks negatively despite positive current fundamentals. The investment in Titan Machinery, Inc., an operator of agricultural and construction equipment dealerships, struggled as investors grew concerned that grain tariffs would negatively impact farmer's equipment purchases. Ironically, Titan's stock soared on the last day of the first quarter due to solid operating results only to be met with macro concerns that plagued the stock throughout the second quarter. Also, within the Industrials sector, the stock of Kelly Services, Inc., a provider of staffing services, reacted strongly to the downside to the company's modestly disappointing margins in the quarter. Our subsequent meeting with the Kelly CEO and CFO confirmed our belief that Kelly is making the right investments to drive revenue growth and margins higher and we now believe the market has over reacted to this temporary situation. Within the Materials sector, the stock of Flotek Industries, Inc. was a disappointment. What we had interpreted as mostly industry-related issues became more clearly company-specific issues, and we exited the position in Flotek. The decline in Flotek's stock was the largest hit to the portfolio during the quarter. We simply got this one wrong and we took the proper course of action after realizing it.

On a positive note, our energy stocks kept pace with the significant increase in stock prices in the quarter. Specifically, Lonestar Energy was up over 90% as the stock had become severely oversold and well out of touch with its positive fundamental reality. W&T Offshore was also a strong performer, returning over 60% as the company continued to improve its balance sheet and executed on several partnerships that will drive production growth while limiting the company's capex requirements. The stock of Gemphire Therapeutics was also a stand out performer, with its stock advancing 56% during the quarter. Gemphire is developing a drug to improve cardio vascular health and we look for further advancement as 2018 progresses.

Characteristics and Positioning

From our perspective, there are two positive indicators of portfolio health. As we discussed last year, 2017 was a year of either winners or losers and very little in between. Stocks that were going up and to the right or down and to the right remained in those trends. In 2018, trends are shifting, and a number of sectors have bottomed and are developing their own positive price momentum and trends. One indicator of this is that our top ten stocks provided a positive return that was nearly twice that of our bottom ten detractors. Last year, one of the issues was that our best stocks could not overcome the return of our worst stocks. That has changed through the first six months of 2018 even though the "cost of disappointment" is still high, meaning stocks that modestly disappoint, like Kelly Services, are met with a disproportionate negative move.

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The other positive indicator is found in the strong value and fundamental characteristics of the portfolio today. In the last two years, the market has largely ignored "value" as a factor. It was even more pronounced in the second quarter as valuation factors were consistently the worst performing factors for returns. We understand investor psychology that brings comfort to investing in stocks where the "trend is your friend" or where near-term momentum begets more short-term momentum. However, to do so without regard to valuation is a danger sign that should not and cannot be ignored. The Micro Cap Value portfolio currently has some of the strongest value characteristics we have ever seen in our ten-year tenure of managing money in this space. Importantly, we have not given up anything on the earnings growth or profitability side to find that value. In short, it looks to us to be one of the best portfolios we have constructed, one that is built to perform in the next 2-3 years, not just the next 2-3 months. What we buy today is what has worked for us over our nearly 25 years of investing and not what is in fashion or in vogue. We are confident our process will work well over the next market cycle.

As always, I am available to meet with you in person or over the phone to discuss the portfolio, the market shifts and our commitment to an improved client experience.

Sincerely yours,

Jeffrey C. Petherick, CFA
Partner

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The Russell Micro Cap® Index measures the performance of the micro-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.