



2Q18 SCV 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 2000[®] 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 cap stocks as overseas concerns arose.

During the second quarter of 2018, small cap stocks outperformed large cap stocks with the Russell 2000[®] Index gaining 7.75% relative to the 3.57% gain in the Russell 1000[®] Index. Value stocks outperformed growth as the Russell 2000[®] Value Index returned 8.3% while the Russell 2000[®] Growth Index gained 7.23%. The Value Index fared better than its growth counterpart due to better returns in the Energy and Real Estate sectors. As these two sectors had the highest overall sector returns during the quarter, the higher relative weighting within the Value index also contributed to the outperformance.

A look at what worked during the quarter indicates that valuation was seemingly 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 Small Cap composite underperformed the Russell 2000[®] Value Index. The portfolio was hurt by negative stock selection in the Industrials and Materials sectors. 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, declined as the Company reported disappointing margins. We maintain that Kelly is making the right investments to drive revenue growth and the market has over reacted to this temporary situation. Within the Materials sector, the stock of Flotek Industries, Inc. was a disappointment. We exited the position in Flotek, a manufacturer of specialty chemicals primarily for the oilfield industry, when management reduced revenue guidance leaving investors little visibility on when, or if, the business will recover. 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 more positive note, the best performing investment during the quarter was in the stock of Carrizo Oil & Gas, Inc. Carrizo reported strong results indicating resolution of certain production issues and logistical challenges. For the quarter, the stock advanced nearly 75%. 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.

At the end of the quarter, the portfolio's three largest positions were the stocks of Carrizo Oil & Gas, Hercules Capital, Inc. and Tristate Capital Holdings, Inc. All three of these investments delivered positive returns, on both an absolute and relative basis, for the quarter. At the end of the first quarter, the portfolio's largest position was in the stock of Cotiviti Holdings, Inc. a provider of payment processing services primarily in the health care industry. During the second quarter, Cotiviti was acquired at a premium and we closed out the investment.

The Small 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.



Sincerely yours,

Jeffrey C. Petherick, CFA
Partner

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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.