NorthPointe Capital
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NorthPointe Capital, LLC
Large Cap Value
1st Quarter 2018

The 1st quarter of 2018 was a tale of two distinct markets. The first half was characterized as the continuation of the growth, momentum and "up and to the right" trade, regardless of the underlying fundamentals. The second half was characterized by what we have been warning about for several quarters now, and that was an initial unwinding of what we have termed "the second largest crowded trade" in market history. Early results in April suggest this trend is continuing.

The steady climb for stocks witnessed throughout 2017 continued during the first several weeks of 2018. The global economic recovery was well underway, and investors had grown accustomed to the gradual move higher in the broad market indices. This calm came to a crashing halt as January ended. Inflation fears were blamed for the dramatic correction that ensued during the first week of February. Investors faced a week in which the Dow Jones Industrial Average fell more than 1,000 points on two separate trading sessions. Volatility indices spiked. The calm and steady investing environment that had persisted for quite some time was over. Modest rallies, and declines, occurred during the remainder of the quarter. Toward the end of March, market declines were attributed to fears of a trade war between the United States and China as the presidents of both nations threatened to impose tariffs.

Both small and large cap stocks were marginally lower for the first quarter of 2018 with the Russell 2000® Index declining -.08% and the Russell 1000® Index declining -.69%. The momentum that continued into the new year drove growth stocks to outperform value stocks as the Russell 1000® Growth Index returned 1.42% while the Russell 1000® Value Index lost -2.83%. The Growth Index fared better than its value counterpart due to much higher exposure to the outperforming Information Technology. Indeed, Information Technology comprises nearly 40% of the Russell 1000® Growth Index while only representing approximately 9% of the Russell 1000® Value Index.

The NorthPointe Large Cap Value Composite produced a gross return of -2.28%, which compares to the -2.83% return of the Russell 1000® Value Index. For the past twelve months, the NorthPointe Large Cap Value Composite had a gross return of 11.26%, which compares to the 6.95% return of the Russell 1000® Value Index.

For the quarter, we experienced strong stock selection across many of the economic sectors. Selectivity was strongest in the Information Technology Sector, with the sector contributing roughly 38 basis points in value add. Selection was weakest in the Health Care Sector, costing the portfolio roughly 21 basis points in value. The top three relative contributors for the quarter were Micron Technology, General Electric, and Applied Materials. Micron Technology is a semiconductor company that manufactures both DRAM and NAND chips. The stock has been a seasoned portfolio position that happened to be 2017's top contributor to performance. The fundamentals of Micron's business continued to improve. In early February the company raised guidance for coming quarter on both the top and bottom line. This preannouncement sparked a further rally in the shares. Micron ended 2017 at $41.12 and was closed out of the portfolio during the middle of March at $60.14, which represents 46% gain for the year. Micron's expected return ranking declined to a point the merited an exit from the portfolio. The stock will be on our radar and should the valuation normalize, Micron could return to the portfolio in the future. General Electric was the top contributor in the Industrial Sector. The share price continued its well documented slide. The stock ended 2017 at $17.45 and is currently trading around $13. We entered 2018 with a small position in GE, which was in effect a negative active weight. In mid-January, the stub position was eliminated from the portfolio. The sale of General Electric is an example of how we can win by not losing. Because the stock was sold from the portfolio and the company remained a large weighting in our benchmark, the portfolio's relative performance was enhanced. The final top contributor was Applied Materials, another semiconductor company. While Micron makes chips, Applied Materials sells the equipment necessary to produce various semiconductors. Applied Materials contributed roughly 16 basis points in value add and remains a portfolio holding. The stock has the highest expected return amongst our Technology holdings. It is a triple threat position. It has Value, Quality, and Momentum in its favor.

The biggest detractor to the portfolio was Cigna. On March 8th it was announced that Cigna would purchase Express Scripts in a stock and cash deal valued at $67 billion. The market punished the stock as concerns mounted that the company's longer-term growth outlook would be challenged. We continue to hold Cigna as our discipline and our process suggests that value remains in the stock. We will monitor the holding with laser focus. If our future work suggests selling the stock, we will. If our models indicate to us that we should commit additional capital to the name, we will add to the position. Our process is designed to take emotion out of the equation and to always act in a manner that is the best economic interest of our clients.

The portfolio's first quarter results were supported by the robust performance of our stock selection model. Our highest ranked securities, our 10 ranks, returned approximately -1.56% during the quarter. Our lowest ranked stocks, our 1 ranks, returned just -5.95% during the period. Allocation to our model account for 60% of the value generated this quarter. The remaining 40% of the portfolio's excess return can be attributed to our stock selection or selectivity, which is chiefly driven by of our qualitative overlay. Within our underlying sub models, three of our models (Interest Rate Sensitive, Cyclical, and Fast Growth) were positive performers. Our Fast Growth model produced the strongest results. Within our Fast Growth model, the top contributing factors were price momentum and downward revisions.

We appreciate the opportunity to provide you an update on the NorthPointe Capital Large Cap Value Strategy. We are excited about the portfolio's current positioning and we are confident in our ability to add value going forward. The current portfolio is selling at a multiple of 13.2 times its twelve month forecasted earnings, which compares to the 14.4 multiple for the strategy's benchmark. The fund has a ROE ratio, Return on Equity, of 14.9% vs. 10.8% for the benchmark. Both metrics suggest that the portfolio's characteristics are in a stronger position than when we wrote to you last quarter. In our view, the portfolio has embedded alpha.

Please rest assured that we shall remain focused on finding unique large cap companies that can grow their business and whose stock price trades below its intrinsic value. We embrace our responsibility to add value to your portfolio and look forward to continuing to attempt to do so for you. If you should desire any further information, please do not hesitate to contact us.

Respectfully,

Peter Cahill, CFA
CIO, Portfolio Manager

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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. 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