NorthPointe Capital
39400 Woodward, Suite 190, Bloomfield Hills, MI 48304

NorthPointe Capital, LLC
Large Cap Value
3rd Quarter 2018

The broad stock market indices reached all-time highs during the quarter. Investors seemed to be buoyed by continued strength in domestic macroeconomic indicators and a tight labor market. Large cap indices moved higher essentially without pause throughout the quarter while other indices such as the Russell 2000® had more volatility in their advance.

During the third quarter of 2018, large cap stocks outperformed small cap stocks with the Russell 1000® Index gaining 7.42% relative to the 3.58% gain in the Russell 2000® Index. This 384bp out performance was a nearly complete reversal from the previous quarter where small caps registered a 418bp lead over large caps. Growth stocks outperformed value as the Russell 1000® Growth Index returned 9.17% while the Russell 1000® Value Index gained 5.7%. The Growth Index moved higher chiefly due to the strong performance of Technology related growth stocks.

Once again, style mattered which is why I would like to spend a minute on Growth versus Value performance. We rarely make short term calls on style investing. The historical evidence is that value outperforms growth in the long run. Trees do not grow to the sky and the Earth has not ended. The evidence also reveals that value does not always win in the short run. We are in such a period now. I will not predict when Value returns to winning. Instead I want to share some perspective. It has been widely reported that over 80% of companies going public this year are not profitable. This is not normal. Some might call it insane or irrational. The last time this condition existed was during the dotcom bubble. I'm reminded of what Warren Buffet wrote in his annual letter to shareholders back in 2000. "value is destroyed, not created, by any business that loses money over its lifetime, no matter how high its interim valuation may get." The bursting of the tech bubble ushered in a period of value winning. I'll be focused on the style environment in the days ahead and writing about it in future commentaries. While I do not mean to convey that I'm on the near-term value soapbox, I can say that I have been thinking deeply about stepping up to one.

The NorthPointe Large Cap Value Composite produced a gross return of 4.74%, which compares to the 5.70% return of the Russell 1000® Value Index. For the past twelve months, the NorthPointe Large Cap Value Composite had a gross return of 9.58%, which compares to the 9.45% return of the Russell 1000® Value Index.

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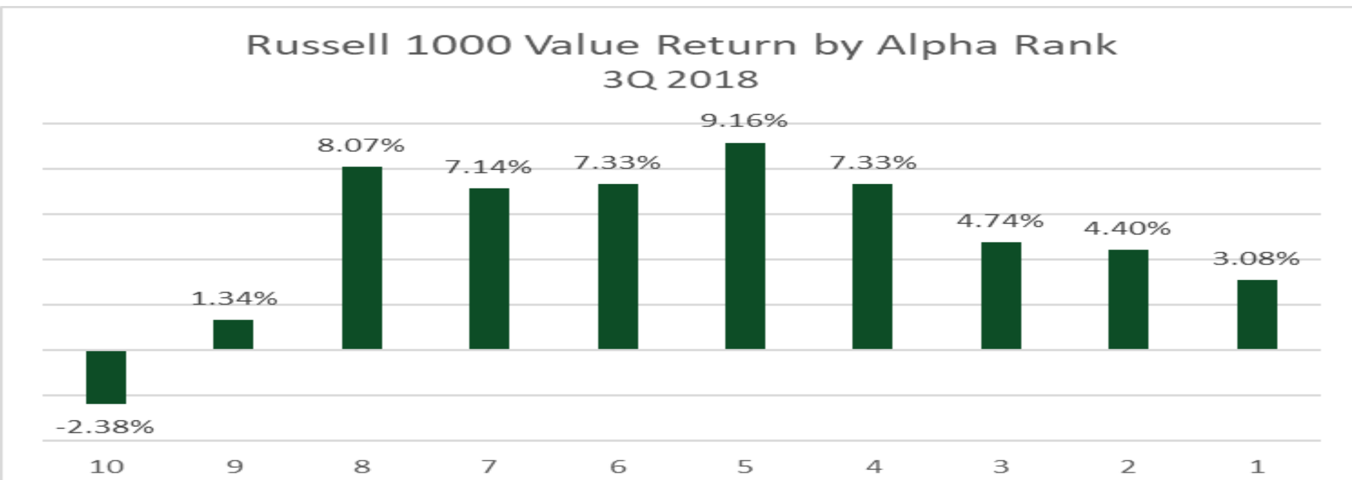
For the quarter, our stock selection was challenged in the Consumer Discretionary, Technology, and Materials sectors. Selectivity was strongest in the Health Care and Financial sectors. Polaris Industries, a manufacturer of Power Sports vehicles and Snowmobiles, underperformed during the quarter as tariff related uncertainty dampened investor enthusiasm. Despite these concerns Polaris remains highly attractive on our stock selection model. It is what we call a triple threat. The stock has positive exposure to value, quality, and momentum. General Motors underperformed during the quarter. Concerns over trade tensions with China, European tariffs, and the North American auto back drop all pressured the shares of GM. We continue to hold the stock in the portfolio. NATFA 2.0 or the USMCA deal has been struck between Mexico, the US, and Canada in the past few days. As the US trade negotiation strategy becomes clearer and additional trade deals are made, the value embedded within both Polaris and GM are in prime position to be unlocked. Westlake Chemical, a chemical manufacturer of vinyls and polymers, missed second quarter forecasted earnings. The company reported $2.22 earnings per share versus the $2.51 consensus figure. This earnings miss pushed the share price downwards. Our work suggests that the sell off was overdone and the name remains in the portfolio.

Two standout areas for the portfolio were the Financial and Health Care sectors. Within the Financial sector, performance was driven by positive selectivity in the Banking industry. Banks make up roughly 10% of the portfolio. The portfolio's bank shares returned 5.7% versus 3.1% for the banks held in the value benchmark. This performance spread contributed roughly thirty basis points of value add to the portfolio. JPMorgan Chase and Citigroup were two of the biggest Bank contributors with both rising nearly 8% during the quarter. Strong economic data suggested to market participants that these shares were worthy of revaluation. Both banks remain core portfolio holdings. Within Health Care, the Health Care Providers and Services industry saw the greatest positive impact. The Health Care Providers held in the portfolio returned 21% for the quarter versus the 15% return for the peer group in the benchmark. This performance gap contributed nearly forty basis points of value add. The two standouts were Cigna and CVS Health. Both companies have announced significant industry changing merger agreements. Cigna is poised to purchase Express Scripts, while CVS desires to buy Aetna. Both mergers are methodically traveling through the regulatory approval process. Signals appeared during the quarter that these mergers were set to clear the Department of Justice's anti-trust regulatory threshold. This aided in propelling the share prices higher. While risks certainly remain in the final outcomes of the proposed mergers and thus the share prices, our work continues to suggest that Cigna and CVS Health should remain portfolio holdings.

The portfolio's third quarter results were dampened by the perverse performance of our stock selection model. Our model seeks to exploit style related factors, or inefficiencies, of value, quality, and momentum.

Please recall that we rank our alphas, or expected returns, by decile. 10s, 9s, and 8s are buy candidates and 1s, 2s, and 3s become candidates for sale. Historically, the 10s and 9s have been the biggest contributors to portfolio's outperformance and overall, they performed the best across the benchmark, but not this quarter. The 10s and 9s were the worst performers. To depict this unusual development, we display a chart below that summarizes our decile performance. What is striking to me is the performance turned in by the 10 ranked securities, these securities historically contribute the greatest to portfolio alpha. The 10s were down roughly -2.4% for the quarter, which negatively compares the to the other deciles average return of nearly 5%. In fact, each of the other nine deciles produced positive returns. This type of model performance makes outperformance an incredibly difficult challenge. In fact, the performance differential in the ten ranked stocks and our consistent allocation to the 10s cost the portfolio 172 basis of value add, more than double the quarter's underperformance.



I dug into our eighteen year plus history of managing this strategy. I sought to gain historical perspective. While what transpired in the second quarter was truly unwelcomed, it has happened in the past. Over the past eighteen years, the unusual model performance that happened in this past three months has only occurred 10 times over 217 rolling quarters. Six of those times occurred around the 9/11 timeframe and aftermath, three occurrences were witnessed during the financial crisis, and the final occurrence was in the summer of 2011 coincident with the downgrading of our sovereign debt by the rating agencies. Part of this reflection is understanding how the portfolio responded following these unusual periods by focusing on the subsequent performance over the next three years. I was not surprised to learn that in 10 out of 10 times the portfolio outperformed. And as some longstanding clients may remember the portfolio went on to outperform for five consecutive years after the summer of 2011.

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Over the past two decades one of the more difficult questions for me to answer to our investors has been: "in what market environments will you underperform?" The reason that answering that question is difficult for me is that I reject its premise. It has been our goal from the outset to manage money that creates alpha irrespective of market environment. If there exists a challenging market environment, then it is our job to rise to future challenges by improving our process. You can go to our website, NorthPointeCapital.com, or for those reading in the acceptable format, please click on the embedded link https://northpointecapital.com/video-library/ to watch a video that answers this important question, as well as additional videos that explain our investment philosophy and process.

I believe our track record reflects our commitment to attaining our goal of consistent outperformance. Clearly, we have had periods of underperformance. I've been known to say that our signals lose effectiveness during times of market dislocation. To be sure 9/11, the financial crisis, the US debt downgrade, and this summer's fear over a global trade war count as market dislocations. Our models have been researched and developed to be resilient. The market environment will cease to be dislocated or our signals will adapt. We stick to our process. Time and time again we have been rewarded for being true to it.

We appreciate the opportunity to provide you with an update on the NorthPointe Capital Large Cap Value Strategy. While we may have been a little long winded in this letter, 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 12.9 times its twelve month forecasted earnings, which compares to the 14.3 multiple for the strategy's benchmark. The fund has a ROE ratio, Return on Equity, of 15.8% vs. 12.7% for the benchmark. These characteristics suggest to us that the portfolio is strongly positioned for future outperformance. In our view, the portfolio has embedded alpha.

There a couple of NorthPointe firm related developments to share with you. John Pearce, my colleague and our Director Quantitative Research, has announced the second addition to the Pearce family is expected to arrive early next winter. John and Tara will be welcoming a baby girl to their family! In other news, Jon Ahwal, our equity trader, passed the CFA Level II examine and now will sit for CFA Level III. Congratulations to Jon!

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