FAIRPOINTE
CAPITAL

FAIRPOINTE ESG EQUITY STRATEGY

2[ND] QUARTER COMMENTARY 2018

This month, the world anxiously watched the news of the boys' soccer team trapped in the caves of Thailand. While we are relieved and impressed with the bravery and efforts that went into this rescue, we are also touched by the knowledge that climate change played a role in this near tragedy. Extreme rainfall has become more frequent, and according to researchers, this is due to climate change. Our ESG strategy seeks companies that are responding to climate change, managing their water usage, thinking about their employees, communities and stakeholders. We believe that investing in companies with good corporate stewardship will enhance financial returns and reduce risks.

As a woman-owned investment firm, one of the goals of our ESG strategy is to encourage and assist in improving gender diversity on corporate boards. Studies have shown that having diversity and females on boards can lead to better community engagement, stronger governance and more sustainable environmental practices. We believe that we can actively assist by having constructive dialogue with the management and board of each company in the portfolio to achieve greater diversity in the future. We also believe that we can recommend a significant number of qualified candidates.

Second Quarter Review

2018 has been a bumpy ride for investors as markets returned to normal levels of volatility after years of relative calm and positive returns. Our portfolio has not been immune to these market forces. In January, our returns were strong, as several of our well-positioned and undervalued holdings were recognized by the market. In February, returns inched downward, but in our view, this short-term volatility was not a reflection of our holdings' long-term value. The potential that was realized and rewarded in January has remained in place to date. In fact, there were signs of strength in June when the portfolio outperformed the benchmark. For the second quarter, the strategy returned 3.61%, compared to 3.57% for the Russell 1000 Index.

As long-term investors, we expect periods of short-term volatility, and we anticipate these dynamics in our process. Looking to the remainder of 2018, we believe this period of volatility will continue due to several factors discussed below. As always, we remain focused on the long-term value of our holdings, rather than the distractions of daily headlines.

After a prolonged period of uncertainty surrounding regulatory requirements in the U.S. and other countries, merger and acquisition (M&A) activity has finally gained momentum. During the first half of 2018, global M&A activity reached $2.5 trillion, its highest level since the global economic crisis of 2008. This represents a year-over-year increase of almost 65%. After the final regulatory approval of the Time Warner acquisition by AT&T, which had been opposed by the federal government, sentiment surrounding M&A activity improved, and the stock prices of many of the companies involved in potential mergers and acquisitions rebounded. Because our investment process seeks to identify companies with strong balance sheets and attractive valuations, our holdings are frequently targets of takeover offers. Increased M&A activity, therefore, often benefits the names in our portfolio.

Westinghouse Air Brake Technology (Wabtec), a new position to the portfolio in Q1, was our best performer for the quarter, up 21%. The company makes equipment for the rail and transit industry. While the sector has been soft, GE's announcement of a refocused strategy on a few core segments put GE's transit business up for grabs, allowing Wabtec to merge with it. The synergies are significant and effectively double the size of the company in a tax-free exchange. We like the company's business as it is focused on providing more fuel-efficient means of transportation for both passengers and goods. The management has a strong track record in safety and internal promotion, however, the board and management team lack diversity. They are aware of this weakness and are actively engaged in STEM (science, technology, engineering and math) programs for girls in high school as well as seeking a more diverse board. Our dialogue with management team on these issues has been positive and productive.

Mattel is another top performer for the portfolio whose returns were enhanced by acquisition interest. Like other toy companies, Mattel's share price was hit hard in the fall of 2017 by the news of the Toys R Us bankruptcy. At the time, Mattel was in the midst of a turnaround, spearheaded by the company's new CEO, that was primarily focused on its legacy products, including Barbie and Hot Wheels. In November 2017, Hasbro reportedly approached Mattel with an acquisition offer, which was apparently rebuffed as too low and premature given the company's reinvigorated trajectory. Although we supported the then CEO's long-term strategy, the board became impatient and replaced her in early 2018 with a current Mattel director who has a history of deal-making with Disney. With a stabilizing business and an improved M&A environment, Mattel seems well positioned to receive renewed take-over interest. As a result, the stock has gone from being our worst performer in 2017 to our top performer in the past few months—up 25% during the quarter.

Other top contributors were Dean Foods, Scholastic, and Juniper Networks.

Detractors to the portfolio were based on individual company factors. Our lowest performing names included Bristol-Myers Squibb, Legg Mason, IBM, Hewlett Packard Enterprise and Meredith Corporation. Bristol-Myers stock price dropped based on commentary from Pfizer that they were not actively looking to acquire Bristol (although longer term we believe it is a possible outcome). No significant issues of concern were present with the other holdings.

Portfolio Changes

New Positions: This quarter we added Molson Coors Brewing, the 3rd largest brewer in the world with strong brands such as Coors, Miller, Leinenkugel's and Blue Moon. Currently, its valuation is extremely attractive and at the low end of its historic range, primarily due to concerns about recent U.S. volume growth. With an innovative management team, the company is primed to generate earnings growth through new products, international opportunities and strong cost discipline. Molson's corporate governance could be improved with additional diversity on the board and removal of their two-class voting structure. They do have majority independence and their senior management team does show good diversity. We intend to encourage improvement in their governance. Environmentally, Molson's has successfully worked to reduce water usage, packaging as well as their carbon footprint. Socially, they score high marks for their treatment and development of their employees and local communities.

We also initiated a position in Tractor Supply, a rural retail lifestyle company that focuses on livestock and pet needs that are not as well suited to e-commerce. They have a leading position in this category, but still have significant room to expand nationally. We took advantage of weakness in the retail sector that created an opportunity to initiate a position at an attractive valuation. Strong corporate governance includes separation of the CEO and Chairman, and an independent board. Executive compensation is reasonable and based on performance and there is diversity on the board. Their environmental efforts are strong, utilizing LEED (Leadership in Energy and Environmental Design) standards for buildings and tightly managing their carbon footprint. We rate Tractor Supply's social efforts positively, with good training and development, and a track record of internal promotion.

Eliminated Positions: Chicago Bridge & Iron and FMC. CB&I was acquired by McDermott International. FMC did not meet our ESG standards.

Reduced Positions: Cree, General Electric, Quanta Services, Varian Medical, VMWare, and Wabtec. VMware and Wabtec were top performers year-to-date, so we trimmed them. We had previously added to our position in General Electric with the stock's weakness to lower our average cost, and slightly trimmed it this quarter on its strength. Cree, Quanta and Varian were reduced based on valuation.

Perspective and Outlook - Has the Fed Supported Momentum Investing?

After years of solid returns, the U.S. equity market is poised for a possible short-term correction and a longer-term shift from momentum to value. In the near term, the market may experience a significant downturn as more extreme trade policy actions and comments continue

More broadly, economic trends indicate that value stocks may soon dominate the U.S. market once again. The bull market of the past 10 years was partly fueled by the Fed's very accommodative monetary policy; and unwinding that policy could slow economic growth. With the Fed increasing rates again in June and signaling that two more hikes could be on the horizon this year, it's becoming increasingly clear that a less accommodating monetary policy is likely. If that occurs, investors might take their profits out of their growth holdings and look for stocks with more intrinsic value, such as the holdings in our portfolio. In fact, in the most recent 30-day period ending July 5, the Russell Midcap Value Index rose 0.67% while the Russell Midcap Growth Index declined 0.89%.

With a P/E multiple much lower than the overall market, our portfolio is well positioned for such a turnaround. The gap between our portfolio's P/E and the gap of the S&P 500's P/E is the largest it has ever been. Although we do not view ourselves as "textbook" value investors, valuation always plays a critical part in our process. Recently, we have become even more value sensitive, given the length of the economic expansion and the historic levels of corporate earnings growth.

We are long-term investors who look for companies with clear indicators of unrecognized value. During this unique period of a prolonged bull market, paired with extremely accommodative monetary policy, the true value of many of our holdings has not yet been unlocked, but underlying company fundamentals remain solid. While some of our investments have already begun to generate strong returns this year, we believe that many others are poised for higher valuations.

While we have a strong valuation discipline, we marry that with companies that exhibit strong or improving ESG factors. Our due diligence process evaluates past behaviors as well as stated goals. We seek to find companies that embrace a holistic and long-term approach to their vision. While disclosure and accounting standards haven't yet kept up with investors' interest, we believe that there is progress, and our qualitative assessments of management's values are critical to our decisions.

Thank you for your continued interest and support.

Thyra E. Zerhusen, Chief Investment Officer
Mary L. Pierson, Portfolio Manager
Frances E. Tuite, CFA, Portfolio Manager

DISCLOSURE

The ESG Equity Composite includes all fully discretionary equity accounts that invest in all cap equities with no fixed income exposure. The ESG Composite represents portfolios that seek to invest in companies that adhere to good environmental, social and governance practices. For comparison purposes the composite is measured against the Russell 1000 index. The Russell 1000 is a market capitalization-weighted index made up of 1,000 large cap stocks that account for upwards of 90% of the market capitalization of companies traded in the U.S. The index is representative of the types of equity assets invested by Fairpointe Capital. Market indices are unmanaged and do not reflect the deduction of fees. You cannot invest in an Index and the performance of the Index does not represent the performance of any specific investment. The minimum account size for this composite is $2.5 million.

Fairpointe Capital LLC (Fairpointe) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Fairpointe has been independently verified for the periods May 1, 2011 through March 31, 2018.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The verification reports are available upon request.

Fairpointe Capital is an independent registered investment adviser. The firm maintains a complete list of composite descriptions which are available upon request. Please send inquiries to mkatauskas@fairpointecapital.com or call 312-477-3300.

Results are based on fully discretionary accounts under management, including any accounts that would no longer be with the firm. Past performance is not indicative of future results. Market, economic, company, and industry specific conditions are considered during the investment selection process. This was a period of generally rising security prices.

The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all dividends, capital gains, and other earnings. Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net of fee performance is calculated using actual fees. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The investment management fee schedule for the composite is 0.85% on the first $10 million and 0.65% on thereafter. Actual investment advisory fees incurred by clients may vary.

The three-year annualized ex-post standard deviation of the composite and the benchmarks are not presented because the composite did not exist prior to 2014.

The ESG Equity Composite was created January 1, 2018.