CORE EQUITY PORTFOLIO REVIEW

Second Quarter 2010

PERFORMANCE COMMENTARY

Though U.S. markets enjoyed a buoyant first quarter, gains generated then were given back and then some in the second quarter. As measured by the Standard & Poor's (S&P) 500 Index, U.S. stocks were down 11.4% in the second quarter, and thus for the year are down 6.7%. The reversal in tone from the more positive first quarter can generally be tied to the fear emanating from Europe concerning the health of Greece, Spain, Portugal and other fiscally challenged European nations, as well as concern over the sustainability of economic growth in the U.S. Other averages retreated, including measures of U.S. small stocks and microcap stocks, such as the Russell 2000 Small Cap Index and Russell Microcap Index, falling 9.9% and 8.9% respectively for the quarter. It is interesting to note that although broader averages representing U.S. stocks are down approximately 7% for the year-to-date, the Russell 2000 Small Cap Index is down about 2% for the year and the Russell Microcap Index is about flat for the year, indicating the first quarter's very strong performance in small capitalization stocks.

	Periods Ending June 30, 2010					
	Quarter	Year-to-date	1 Year	3 Years	5 Years	10 Years
Core Equity Composite – NET	**-9.0%**	**-2.8%**	**14.5%**	**-2.6%**	**3.9%**	**4.2%**
S&P 500 Index	-11.5%	-6.7%	14.3%	-9.8%	-0.8%	-1.6%

Composite performance is reported **NET** of fees and expenses. Please refer to the disclosures at the end of this report.

The Core Equity strategy, though enjoying positive relative performance versus its benchmark for the quarter, was still down during the period. The strong market pullback at the tail-end of June made for a very short list of positive contributors for the quarter. The top performers for the past three months are the same names on the list from the prior quarter, for the same reasons described in that quarter's review: **Ladish (LDSH),** up 12%; **Martek Biosciences (MATK),** up 5%**;** plus **Rovi Corporation (ROVI)** and **Sara Lee (SLE),** both up 2%**.** And our mid-June liquidation of **VeriSign (VRSN)**, described below, locked in that holding's 11% gain for the quarter.

Overall weakness in the broader market hurt both smaller and larger capitalization names in the portfolio. The second quarter's biggest hit was also a repeat from the first quarter: **Monsanto (MON)**. The market continued to react strongly to the financial impact of pricing pressures from generic alternatives to the company's off-patent herbicide, Roundup, driving the stock's price down into the mid $40's by quarter end. While disappointed in our overconfidence in management's ability to work through the herbicide division's financial challenges, we continue to believe in the strength of the company's seed business. Our adjusted valuation target, now in the high $60's, leaves room for improvement. In fact, in the two weeks since quarter-end, the stock has seen a strong rebound into the mid $50's.

PORTFOLIO ACTIVITY

Unlike our previous letter, in which there were no major new purchases or sales to announce, this current communication has several portfolio changes to report. First, as mentioned above, we sold our position in **VeriSign (VRSN)**. VeriSign is a mature technology company based in California that over the years had built itself up through acquisition, only to strip down more recently to two basic but we believed strong

businesses: domain name registration (tracking what entity owns what .com or .net name) and web transaction security certificates (which secure transactions between consumers and web sites). Our belief at the time of initiating purchase, in mid-2009, was that these two businesses would provide a growing but stable cash flow. The fact that VeriSign's business was not too cyclical compared to other growing technology companies gave us confidence that it would be a good fit for Core Equity portfolios.

From our initial purchase price of about $20 per share, VeriSign's stock price rose to the high $20's. Then during this past May, VeriSign's management announced that it was selling one of the two businesses, the security certificate business, to Symantec. The price was a good one, enough to move VeriSign's stock to new price heights. The challenge for us was that this development departed from management's stated goal to slowly build upon the two businesses with both new services and small acquisitions. Furthermore, when we researched the reasons why management did the deal, the answers were evasive. We now wonder if VeriSign is either going to go private or sell the one remaining business to another entity. Given our expectations for the current remaining business and a stock price in the upper $20's, we decided to sell and move on.

A second position sale during the quarter was **Bristol-Myers Squibb (BMY)**. Please recall that our Core Equity portfolios offset growth-oriented stocks that provide appreciation potential with what we believe are attractively valued large, stable companies. BMY is definitely of the latter variety. We first began building our BMY position at a price in the high-teens, when we purchased it despite the expected 2012 expiration of a very valuable set of patents protecting the drug Plavix, a big revenue generator for BMY. At that time management was selling off non-pharmaceutical assets and using proceeds to bolster the company's pipeline, and also cutting overhead costs. We, as well as others, became suspicious that management has been preparing BMY to be acquired. Given the stock reaching our estimate of ongoing fair value, we decided to sell our position in BMY this past April, although we still admire BMY's properties and management's focus. Frankly, we wish the other pharmaceutical companies had managements that were as intelligently active as BMY's.

A new name in the Core Equity portfolio this quarter is **CVS Caremark (CVS)**. Behind this purchase is our interest in the rising use of generic therapeutics in healthcare around the world. A group of companies that have benefited from this trend and will continue to do so are pharmacy benefit managers, or PBM's. Though these companies provide a growing list of services to large purchasers of healthcare services, their prime offerings revolve around drug procurement and distribution services. This business has been around for years and will likely continue its attractive growth given the increasing use of generics.

CVS Caremark has an unusual business model relative to its PBM peers, in that it is not just a PBM but also a retail drug chain. Some see this dual focus as creating a potential conflict of interest (from the PBM segment steering drug purchasing activity to CVS facilities and away from other pharmacy retailers) and believe it is the reason behind decreased sales the past two years in the company's PBM segment. We think otherwise, believing the company's PBM challenges have been due to implementation errors, and that the introduction of PBM head Per Lofberg, a proven industry manager, will begin to stabilize the PBM segment's results. Furthermore, the CVS retail operations continue to outperform competitors such as Walgreen.

The slip-ups by the PBM segment have created a very large valuation discount in CVS Caremark's stock versus those of Medco and Express Scripts (after extracting out the value of the CVS side). The bottom line is that the Caremark PBM segment is a valuable asset that should be realizing its value in rising cash flows

and valuation but it is not. Our expectation is that CVS Caremark will stabilize the PBM operation while continuing to successfully manage its retail operations.

CVS Caremark, as opposed to the larger PBM's Medco or Express Scripts, is the more appropriate choice for monetizing the generic drug/PBM trend in Core Equity portfolios due to its dual business strategy and current valuation. Should the potential from CVS' PBM segment not materialize, the market's reaction will be muted by the stock's current discount and the significant contributions of its retail operations. By way of a contrast, Express Scripts, with no other business lines, is a pure PBM play and thus may have more upside potential as the generic drug/PBM trend unfolds. However, with higher multiples embedded in Express Scripts' stock price, if things don't go well, the market's reaction could be harsher. For our Core Equity strategy, with its dual objective of outperformance versus a general market benchmark *plus* downside protection, the management of risk is as important as the focus on opportunity. (In the interest of full disclosure, Express Scripts is held in our more aggressively invested Growth Equity portfolios.)

Finally, you may recall that in our last letter we suggested, given the relative valuation attractiveness of large, multinational companies with multiple product lines, that clients might see the purchase of a 'boring' company in the not-too-distant future. This quarter we bought such a stock in **Pepsico (PEP)**. We would guess that most clients are familiar with Pepsico, the purveyor of Pepsi and Diet-Pepsi colas and Frito-Lay snack foods as well as Gatorade athletic drinks and Quaker Oats breakfast foods. Pepsico's non-US business fits well with our interest in companies that can capitalize on the trend of stronger growth rates outside the U.S. Forty-eight percent of the company's sales are in countries outside the U.S., and a large portion of that is sold into emerging market countries that are currently enjoying growth rates exceeding those in the U.S., western Europe and Japan. The North American beverage market, largely made up of sales in the U.S., has been a weakness for Pepsico. The revenue from this business segment has shown a surprising sensitivity to the economy and some of this has been due to both weakness in marketing its product (lack of new product, refresh rates of older product) as well as in lethargic distribution strategies. To remedy this, Pepsico decided to modify its business model and acquire complete control of its major bottlers in the U.S. We believe this was a smart move. Though it does add to the rate of capital consumption required to maintain the total business, we believe the trade-off in adding to growth will be worth it. Thus our expectations are for continued high growth in the emerging foreign markets, reasonable growth in the company's snack food and athletic drink products in mature markets, and a turnaround in the company's North American beverage segment.

CASH, CASH EVERYWHERE

Mentioned in the business press repeatedly, and frankly, we've talked about it enough ourselves, has been the balance sheet health of larger companies, especially those in the U.S. Most recently, *Barron's* highlighted the fact that larger U.S. companies, unlike U.S. consumers or the U.S. government, are "lean, financially sturdy and richer in cash than they have been for decades." The article goes on to quote a study done by Credit Suisse saying that cash holdings by S&P 500 companies, measured as a percentage of corporate assets, are at or near record levels. Looking at individual companies from the bottom-up as we do here at Princeton Capital, we can only concur. Strong, flexible balance sheets are important criteria for potential Core Equity portfolio candidates, and we award a premium valuation to companies able to maintain such a healthy state, though this is not always recognized by the market at times. *Barron's* goes on to comment that perhaps the spending of this cash, either in merger and acquisition activity or increased capital spending, will lead to higher growth.

We agree with such optimism, but as always offer a caution: big cash balances do not assure wise spending of said cash. No one enjoys arriving at work in the morning to see a portfolio holding down 15% in pre-market trading on the news that company management just purchased a second company for a very high price—too high a price as it would usually turn out—after several years of telling investors that they promise (promise!) to maintain investing restraint. We do our best to make sure we invest in companies whose managements have shown a consistent track record of wise asset management. Frankly, we feel this is an area on which our analytical brethren do not focus, instead concentrating on sales trends and margins. Obviously, these are important factors, but all it takes is one large, or a series of small, ill-conceived investments to render the economics of the business or businesses unattractive.

Our point is that strong balance sheets are a prerequisite for safety and long-term growth. But the cash balance and the company's ability to generate cash are not the only ingredients. It also requires a management team that knows how to deploy cash intelligently. The search for such managements and the right situations in which they can operate, keeps us busy here at Princeton Capital.

DISCLOSURES: The Core Equity Composite is comprised of discretionary taxable and tax-exempt accounts of similar risk and investment objectives that are managed according to Princeton Capital Management's conservative, equity oriented investment strategy. Prior to 1/1/09 this strategy and its composite were marketed as Princeton Capital Management's Growth and Income investment product. While the strategy has not changed, it was renamed to reflect its intended strategic role within an investment program. Accounts are included in the composite at the beginning of the first full calendar month each account is fully reflective of the investment strategy. Results are calculated internally using Advent portfolio accounting software and information provided by outside custodial firms. Composite and index performance valuations and calculations include dividends, interest and other earnings and are stated in US dollars. Performance figures for periods one year and longer are annualized. Composite returns are asset weighted and are reported net of fees and commissions. Performance results for individual accounts may vary due to the timing of investments, size of positions, fees, and other reasons. Additional information regarding policies for calculating and reporting returns is available upon request. A client's returns may be reduced by other expenses incurred in the management of the client's portfolio. PAST PERFORMANCE SHOULD NOT BE CONSTRUED AS A GUARANTEE OF FUTURE PERFORMANCE.