CORE EQUITY PORTFOLIO REVIEW

Fourth Quarter 2010

PERFORMANCE COMMENTARY

After a disappointing first half of 2010, the equity markets (as measured by the S&P 500 Index) came roaring back to life, turning in two back-to-back quarters of double-digit gains. The market's third quarter 11.3% return was followed by a similarly enthusiastic 10.8% fourth quarter advance, much of it coming in December.

	Periods Ending December 31, 2010				
	Quarter	1 Year	3 Years	5 Years	10 Years
Core Equity Composite – NET	**13.7%**	**21.9%**	**4.0%**	**6.8%**	**7.7%**
S&P 500 Index	10.8%	15.1%	-2.9%	2.3%	1.4%

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

The fact that Core Equity outperformed in the fourth quarter - a period of blazing performance by the market - is a bit unusual. As we've said before, Core Equity has twin goals: to outperform a broad U.S. index such as the S&P 500 over a market cycle; and to protect the portfolio against significant downside volatility. In pursuit of these joint goals, Core Equity portfolios typically maintain a conservative undertone – through cautious stock selection and/or a willingness to retain more cash when the supply of appropriately attractive stock opportunities is less robust. This conservative profile typically performs well in average markets and is usually a strong advantage in market downdrafts, but can be expected to mute the strategy's performance relative to the market during strong advances (greater than 10% for a three month period). For the most recent quarter, Core Equity's outperformance was due to several individual stock holdings that were involved in actual takeovers and/or takeover speculation. Additionally, several positions generated noteworthy price moves as a result of good earnings news and participation in favorable industry trends.

Front and center among the good news for the quarter was the announced takeover of **Ladish (LDSH)** by Allegheny Technologies (ATI). (A discussion of our trend, business model and valuation reasons for holding Ladish is included in our Q1 2010 letter. In a nutshell, we believed it to be an attractive beneficiary of a resurgent commercial aerospace cycle in the next several years.) Ladish's stock was trading in the low-$30's when Allegheny announced its $48 per share offer for the company in mid-November, providing a nearly 50% price jump for shareholders. Ladish also did very nicely earlier in 2010, its stock price moved up over 200% over the course of the year.

A second holding benefiting from takeover news was **Martek Biosciences (MATK)**, a company discussed at length in our Q3 2010 letter as one of the performance laggards for that period. Martek had been a bit of a dullard since we purchased it in 2009. We at Princeton Capital are attracted to organizations like Martek whose research efforts generate a technology or process that is genuinely different than what is currently available in the marketplace and truly advances the state-of-the-art. However, the challenge is that great advances need to be commercialized, marketed and distributed in order to yield financial rewards. Unfortunately, innovative companies are not always successful at commercializing their advances. In short, the best technology alone doesn't assure a financial win. In the 1990's and early 2000's Martek built up a bit of a technology advantage surrounding the manipulation of algae, enough to make us take notice and frankly hope for numerous commercial product strategies to emerge from the company's knowledge gains. However, there has been thus far only one financially rewarding commercialization effort, with DHA, a chemical supplement used as a food additive. Though we're as happy as anyone about an immediate takeover-fueled bump up (38%) in the company's stock price, we are sincerely disappointed at the frustrating ending to a story that failed to unfold as we hoped. We will continue to follow Martek's new parent, the Dutch chemical company Royal DSM, to see if it can successfully commercialize Martek's research assets.

Rounding out the top five performers for the quarter were **Monsanto (MON)**, **Sara Lee (SLE)** and **Ametek (AME)**, up 45%, 30%, and 23% respectively. On the flip side, three of the five weakest performers had positive returns: **United Parcel Service (UPS)** posted a respectable 9% gain, **Henry Schein (HSIC)** was up nearly 5%, and **Duke Energy**

(DUK) returned almost 2%. The only two negative performers in the quarter were **Boeing (BA)**, down about 1.6% for the quarter, and **PepsiCo (PEP)**, down about 1.1% for the quarter. Both reported news that meant a delay in the progress we had hoped would unfold during 2010. Boeing experienced another delay in the testing of its 787 aircraft, in part due to a fire that erupted on one of its test airplanes. The cause of the fire appears quite fixable, but there is another delay issue at work: there were rumors prior to the fire that Boeing had accumulated several engineering alterations that would have to be retrofitted onto planes already built, meaning that at least another three month delay was likely. Odds are that the first 787 will be delivered in September of 2011, about six months later than Boeing is still suggesting as its first delivery date. We continue to believe that the 787 will be a profitable and popular plane in the next several years but like others are frustrated at the delays.

As we stated in our rationale for purchasing PepsiCo (Q2 2010 letter), we expected that the company would be able to engineer stronger growth in 2011 in the North American beverage market (which currently generates less than 25% of the company's total revenues) by acquiring complete control of its major bottlers in the U.S. As the third quarter showed and likely the fourth quarter as well, Coca Cola is proving competitive, which means PepsiCo will likely have to increase its marketing expenditure in 2011. This expectation of added pressure on the company's margins has lead to weakness in PepsiCo's stock price. We remain confident that PepsiCo's management can turn the unit around while continuing to enjoy growth from its exposure to developing markets around the world.

PORTFOLIO ACTIVITY

Activity in the fourth quarter was limited to the sale of Ladish from most Core Equity accounts soon after the announced takeover. For those taxable Core Equity accounts in which retaining Ladish another month or so would mean the difference between short-term and long-term gains, we are holding onto the stock until it becomes long-term.

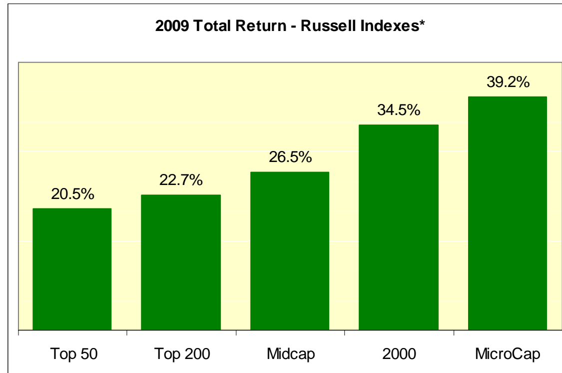
There were no major purchases during the quarter.

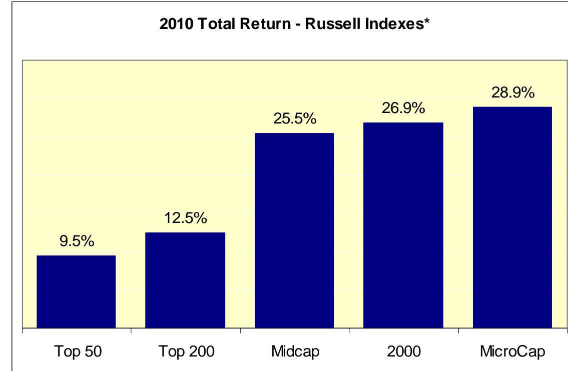
Portfolio turnover for the year is under 30%, towards the lower end of the normal 25% - 50% range for Core Equity portfolios. (Turnover is a measure of how frequently assets in a portfolio are bought and sold.) As a reminder, during tumultuous periods in the market (e.g., mid-2008 to mid-2009) clients can expect to see turnover rates at the higher end of the range, whereas in quieter periods, one can expect turnover at the lower end of the range.

OUTLOOK FOR 2011

We'd like to begin our outlook for 2011 by revisiting a couple of observations made at this time last year about our outlook for 2010. First, we suggested a more 'normal' market environment for 2010 in which 2009's general upswing in all stocks would be replaced by an environment in which select companies and industries would be recognized for their superior exposure to growth trends, reasonable valuation and superior business models. We believe this has been the case for 2010: companies have been especially rewarded for superior growth in revenues and earnings. Twelve months ago we also questioned how much further the stock prices of companies already exposed to strong growth trends could continue to climb. We were wrong here, as the stocks of companies that enjoyed strong revenue or earnings growth in 2009 climbed substantially further in 2010. Recognizing this continuation of 2009's return pattern is key to understanding our outlook for 2011, as explained below.

A year ago, our Q4 2009 letter included a chart showing the relative outperformance of riskier stocks (riskier defined for the sake of simplicity by market capitalization; smaller cap stocks being considered riskier than larger cap stocks on average).



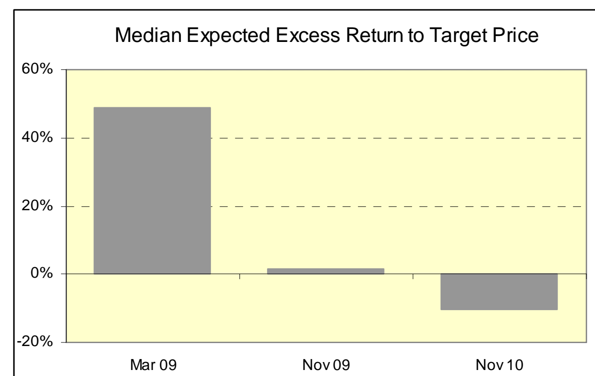


* Source: Russell Investments (www.russell.com)

2010's returns were not much different. In fact, in a recent Associated Press article, the best performing stocks in 2010 were the stocks of companies with attributes considered as signs of greater risk: small companies, companies whose debt is rated as non-investment grade, companies whose stock is a favorite of short-sellers (investors betting the stock price will go down), and companies that had already enjoyed large stock price rises in 2009.

This has led to a bifurcated market as we head into 2011 in which the stock prices of more moderately growing companies (typically larger capitalization companies, multi-nationals, and firms with good balance sheets and high return on capital) are becoming increasingly attractive when compared to riskier and now more expensive companies (those that are smaller, with limited product lines, limited geographic diversity to its revenue streams, or have poorer balance sheets or sky high valuations).

Recognizing the potential for different risk/return patterns within the universe of publicly traded equities, we view the stock market not as a single asset class on which we make global observations and estimations, but as an incredibly diverse set of distinct opportunities whose outcomes are largely dependent upon situation-specific variables. Yet even when examining these distinct opportunities from the ground up, some general observations may be reached.



For example, as an analytical discipline, we determine a valuation range for almost every company we follow, that is, a reasonable expected range of prices for the stock, from very optimistic to very pessimistic. We use standard tools of valuation to determine the range, such as discounted cash flow, comparable multiples, and historic multiples. The mid-point of that range becomes our target price. It is the price we believe is a reasonable value for the stock over a fairly wide analytical time horizon such as seven years. The chart nearby displays the median excess return expected from the stocks we follow, at different points in time. When we say expected excess return, we mean the potential level of return over and above what the market is normally expected to provide. In March of 2009, it was apparent that just about any stock we followed could have provided excess return over the market. It was akin to shooting fish in a barrel. Yet in merely eight months' time, most of that potential excess return disappeared due to fast rising stock prices, suggesting that valuations in general were relatively reasonable. As of the end of November of 2010, the median expected excess return from the stocks we follow had turned negative, suggesting a degree of overvaluation in some areas of the market. While we still see plenty of companies with positive expected excess return, our focus on the valuation characteristics of individual opportunities is even more important.

What does this mean in general, and for Core Equity portfolios in particular? Generally, it means we find it tougher, if not impossible, to justify continuing to hold much less purchase those stocks that have done very well and now sport extended valuations. For Core Equity portfolios our implementation of this conclusion may not be as noticeable as in our other, more aggressive strategies since Core Equity portfolios are already particularly sensitive to the risk of extended valuations. However as we warned in a similar discussion in our Q1 2010 letter ("Some Thoughts Looking Forward"), expect future Core Equity purchases to "look pretty boring—that is favor the larger, more diverse companies over the smaller ones with limited function." This is because valuations for the larger, more diverse companies are becoming more and more attractive relative to the smaller companies we follow. There are exceptions of course, and some of those will find their way into Core no doubt, but in general, it is becoming more and more difficult to rationalize the purchase of shares of those smaller or cyclical companies that are enjoying very strong earnings or revenue growth.

The economic environment remains the same. We see a muted recovery in the developed nations and a continuing strong recovery in the so-called developing nations, though as we've discussed in past letters we believe we will see an improving employment situation in the U.S. Companies cannot continue to benefit from the large scale increases in productivity they have enjoyed by leveraging labor via offshoring, overtime and utilizing temporary workers. U.S. companies will have to begin hiring full-time equivalent employees and we believe it will be sooner rather than later. Clients have asked us about interest rates, especially the large move upward in the ten-year and thirty-year U.S. Treasury rates: we've noticed, but are not yet alarmed. Rates were driven down to unrealistically low levels and were bound to rise once better economic data was being reported, and so they have. The next step is for the Fed to begin raising short term rates, which we hope happens soon. This may have a short term effect of stifling the securities markets, but it will signal the return to a more normal economic environment - which we welcome.

The political environment is more benign due to the results of this past fall's elections. As we noted in our Q3 2010 letter, we hoped the first item on Congress's agenda would be to extend the Bush tax rates and this did occur. To raise taxes in the current slow recovery would be anathema to supporting such a recovery. Higher gasoline prices are enough of a headwind for the average American wage earner without having to foot the bill for higher taxes. We are guessing that higher income tax rates will eventually result but only after unemployment recedes. Still, we must wait for the new Congress to convene and begin its legislative debate with President Obama. As we said last quarter, less belligerent trade talk and at least a level income tax burden are important near term issues to watch.

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. The S&P 500 Index is an unmanaged index considered generally representative of the U.S. stock market. 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. A client's returns may be reduced by other expenses incurred in the management of the client's portfolio. Additional information regarding policies for calculating and reporting returns is available upon request. PAST PERFORMANCE SHOULD NOT BE CONSTRUED AS A GUARANTEE OF FUTURE PERFORMANCE. The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for advisory clients, and the reader should not assume that investments in the securities identified or discussed were or will be profitable. The stocks named as the top or bottom five contributors to performance for the period are based on a representative portfolio (Princeton Capital's oldest Core Equity wrap account portfolio; also a member of the Core Equity composite) and have been identified through a report generated by Princeton Capital Management's Advent portfolio accounting system. Further detail on the contribution to performance calculation, which takes into consideration the weighting of every holding in the representative account, as well as a list showing every holding's contribution to performance for the period, is available by contacting Princeton Capital Management at info@pcminvest.com.