GROWTH 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
Growth Equity Composite – NET	**14.8%**	**27.8%**	**2.9%**	**5.6%**	**5.2%**
S&P 500 Index	10.8%	15.1%	-2.9%	2.3%	1.4%
Russell 3000 Growth Index	12.3%	17.6%	-0.3%	3.9%	0.3%

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

Growth Equity's strong outperformance in the fourth quarter and for the full year was helped by the world markets' continued fascination with stocks of companies showing near-term revenue and earnings momentum - such as companies exposed to overseas industrial markets and commodities, or technology products and services in demand both in the U.S. and in non-U.S. markets. We mentioned in last year's Q4 2009 letter our expectation that the coming year would be an environment in which stock prices would be driven to a greater extent by individual company prospects, and this we did observe in the markets and in our clients' portfolios in 2010. In that letter we also questioned the sustainability of the market's focused attention on the riskier sectors and companies of the market. This observation was also on target, but not for long. After some first half wobbles, the market again embraced such stocks as the developed economies showed signs of life. We again question the sustainability of the stock market's affection, at least in the near term, towards these stocks and explain this position in greater detail in this letter's later discussion of our outlook for 2011. (We figure if we stick to the same note, we'll eventually be correct!)

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 stock that had been a laggard during the first nine months of 2010 but did quite well in the fourth quarter was **MAKO Surgical (MAKO)**, up about 62% in the fourth quarter. MAKO is a young, small company that is commencing the production and sale of its surgical devices and supplies that treat orthopaedic maladies. We have been attracted to the company's business model as it is akin to the successful razor-and-razorblade model leveraged by another surgical device company and Growth Equity holding, **Intuitive Surgical (ISRG)**. In MAKO's case, the company sells both the equipment used to prepare the diseased area of the bone as well as the joint replacement implants. We were also attracted to the stock's valuation as its share price had fallen from the mid-teens to the $11-$12 range earlier in the year due to some revenues falling below expectations. As 2010 progressed, management signaled a slightly better near-term revenue outlook and the stock price has responded. The company's favorable prospects are also helped by some of the trends buffeting the healthcare area, which are described in greater detail further into this letter.

Growth Equity portfolios also benefited this quarter from the presence of **IMAX (IMAX)**, a stock we've discussed in detail most recently in the Q1 2010 letter. IMAX was up nearly 56% during the last quarter of 2010 and just about doubled for the full year. Briefly, IMAX manufactures large format movie projection and sound systems that provide a unique viewing experience, especially in 3D. Movie theater owners, eager to increase revenues in any way possible, have found the IMAX format to be quite valuable in allowing them to capture higher ticket prices for the experience.

This trend, plus IMAX's push into non-U.S. markets has provided substantial growth over the past two years and we expect it to continue.

Rounding out the top five contributors to performance for the quarter were **Monsanto (MON)**, and **Universal Display (PANL)**, up 45% and 34% respectively.

On the flip side, there were a total of four holdings with negative performance for the quarter. The portfolio's largest detractor was **Nektar Therapeutics (NKTR)**, which was down about 12% for the quarter. We were first attracted to Nektar because of its unique ownership of a class of therapeutic technology called PEGylation. PEGylation is the process of attaching a polyethylene glycol polymer to a therapeutic molecule which masks the therapeutic from the body's immune system. The masking allows the therapeutic to avoid an anti-immune response while also allowing for longer circulatory duration thus making the therapeutic agent more productive than without the PEG polymer attached. Nektar had reported in June some very good Phase II clinical results concerning its NKTR-102 therapeutic which is being tested to combat metastatic breast cancer. The stock moved up on the expectation that Nektar would then move on to Phase III but also partner with a larger, well-heeled pharmaceutical company. Nektar decided to move on to Phase III, but not to partner with another company. We believe Nektar is doing this because it believes its study results are indicative of a strong potential for NKTR-102, but it does increase risk. We still believe in the PEGylation technology and Nektar's ability to formulate a winning therapeutic using the technology, and are thus holding on to the position.

Another disappointment came from the medical device company **SonoSite (SONO)**. SonoSite, a maker of handheld ultrasound systems used in many different types of clinical settings, from operating room to battlefield, appears to us to have corrected this past quarter after experiencing a better-than-expected snapback in hospital spending during 2010. Trends in the healthcare industry, such as a near-term trend of economic sensitivity and a secular trend of cost containment, affect not only medical devices but a range of healthcare service and product providers. These trends continue to be tricky to navigate. In recessions past, a large swath of the healthcare provision industry was able to weather the poor economies with little effect on demand or revenues. That was not the case in the most recent recessionary period, during which many healthcare consumers cut back and continue to maintain lower levels of consumption in all areas of healthcare including pharmaceutical purchases. This of course had a negative effect on healthcare providers themselves, forcing cutbacks on capital expenditures for medical machinery and devices. As stated above, we have seen a snap back in demand for a wide range of medical products and services but there remains the ongoing secular worry of cost containment. Whether enforced by government control or due to free markets, cost pressures on the healthcare system are brewing. That which is cheaper - drugs, procedures, services, medical devices - or that which allows for cheaper provision, will continue to be in demand. That which does not provide greater efficiency in healthcare delivery is going to have trouble longer term. We are focused on companies that will do well in a price constrained environment: generic drug makers, distributors, pharmacy benefit managers and healthcare systems providers. Though we don't make promises, device makers, especially those not facilitating greater doctor productivity, will likely not be found in our Growth Equity portfolios in the future.

The remaining two stocks with a negative impact on the portfolio this quarter were **Aruba Networks (ARUN)** and **Seattle Genetics (SGEN)**, both down nearly 4%. The position with the fifth lowest contribution to return this quarter was **Vical (VICL),** a stock that was sold from the portfolio during the quarter (see below). Given the timing of the sale, the stock had no impact on the portfolio's performance for the quarter.

PORTFOLIO ACTIVITY

Activity in the fourth quarter was limited to a few sales and one purchase. **Crucell (CRXL)** and **Ladish (LDSH)** received takeover offers and we decided to sell them both from most Growth Equity accounts soon after the takeover announcements. For those taxable Growth Equity accounts in which retaining Crucell or Ladish another month or so would mean the difference between short-term and long-term gains, we are holding onto the stocks until they become long-term. We also sold **Vical (VICL)** during the quarter. We discussed Vical in our Q3 2010 letter, noting the disappointing results in clinical trials of a promising drug to treat a disease called critical limb ischemia, or CLI. We mentioned in that letter that there was a good chance we would exit the position after re-examining its drug pipeline; our

review concluded that the probability of success was not high enough in the near-term to justify holding it, thus we liquidated the position.

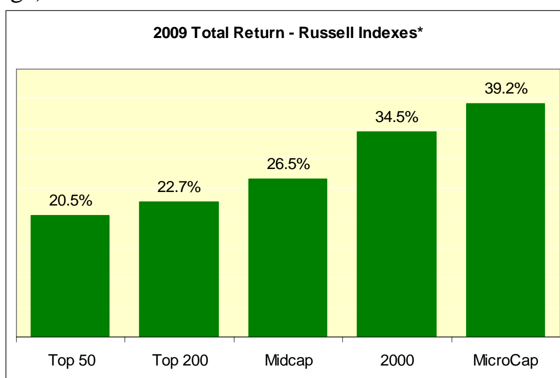
The new purchase during the quarter was **Morphosys (MPSYF)**, a small therapeutic development company based outside of Munich, Germany. One of the things about the investment profession we find fascinating is watching business models unfold in the industries we follow. One of the most straightforward has been the drug industry: find a venture capitalist, raise money to fund research, do the research, show progress on the drug, go public to raise more money and do more research, and lastly sell yourself to a larger drug company. This is still a widely followed path, however the newer biological science involving the manipulation of proteins is opening the door to a different business model that allows for less financial risk. Companies such as **Seattle Genetics (SGEN)** and Morphosys are developing analytical tool platforms to aid in the discovery of biologic therapeutics that they license to others, generating cash flow. These companies also have their own proprietary discovery efforts. To some extent, these proprietary efforts compete with those of the companies licensing the platform used to develop drugs, but the model is working as it allows other drug makers to lower their own costs by not having to develop similar platforms. Because of Morphosys' attractive model and recent success in its proprietary discovery effort, we have initiated a position in the stock.

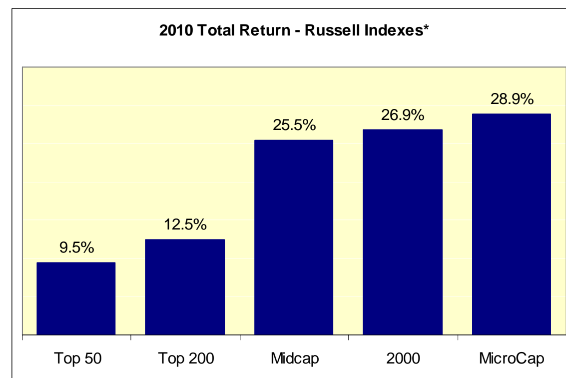
Portfolio turnover for the year is under 30%, towards the lower end of the normal 25% - 50% range for Growth Equity portfolios. (Turnover is a measure of how frequently assets in a portfolio are bought and sold.) As a reminder, during tumultuous periods in the market (e.g., mid-2008 to mid-2009) clients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





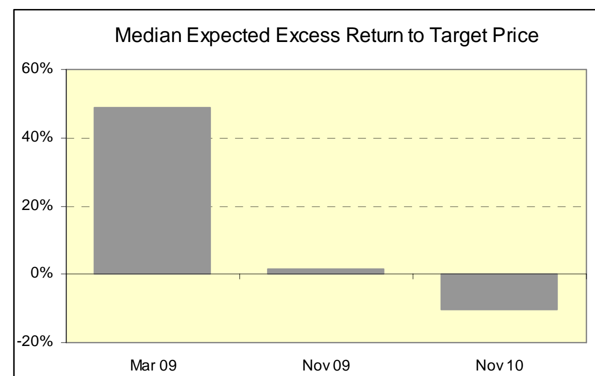
- Source: Russell Investments (www.russell.com)

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 Growth 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 Growth Equity portfolios you should not be surprised to see a shift out of a few of the smaller companies that have enjoyed a nice run in the past eighteen months and into larger, more stable companies with expected earnings and revenue growth rates that are more moderate than those of the companies we are selling. 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 Growth Equity 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 Growth Equity Composite is comprised of discretionary taxable and tax-exempt accounts of similar risk and investment objectives that are managed for growth. 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. The Russell 3000 Growth Index is an unmanaged index constructed to provide a comprehensive, unbiased, and stable barometer of the growth segment of the broad 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 Growth Equity wrap account portfolio; also a member of the Growth 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.