# GROWTH EQUITY REVIEW

*Third Quarter 2013*

## PERFORMANCE COMMENTARY

Our investment team has collectively managed assets through the cold war era of the 50's and the Cuban Missile crisis, the social unrest of Vietnam and the Nixon resignation, the Volker induced "20%" interest rates and energy crisis of the 70's, portfolio insurance and the '87 crash, the Long Term Capital and currency crisis of the early 90's, the dot com bubble, and the financial follies and ensuing debacle of 2008.

With today's ever present media there always seems to be a new "crisis" that dominates headlines, commandeering commentator's voices and ensnaring emotions or minds. If we look back to the past few years there have been several pending collapses of the European banking system or economic recessions, imminent double dips in our economy here at home, and several political crises of debt ceilings. We began the year dealing with sequestration and the fiscal cliff and ended Q3 with a government shutdown and threatened repudiation of our debts.

We have taken these recent, and what we view as mostly manufactured, crises in stride and remain optimistic. We continue to believe that the economic recovery is in place on a global basis and opportunities exist to earn a significant return as well. Through it all the market has done the same and has moved, although haltingly at times, markedly higher.

Both for the quarter and the year to date, this has been another wonderful year for equity investors and we have more than kept pace with generalized market returns.

| | | | Periods Ending September 30, 2013 | | | | |
|---|---|---|---|---|---|---|---|
| | **QTR** | **YTD** | **1 Yr** | **3 Yrs** | **5 Yrs** | **7 Yrs** | **10 Yrs** |
| **Growth Equity - NET** | **6.3** | **23.4** | **22.9** | **16.1** | **11.6** | **8.0** | **9.1** |
| Russell 3000 Growth Index | 8.5 | 21.8 | 20.3 | 17.2 | 12.2 | 7.7 | 8.0 |
| S&P 500 Index | 5.2 | 19.8 | 19.3 | 16.3 | 10.0 | 5.6 | 7.6 |

Composite performance is reported NET of fees and expenses. Please refer to the disclosures at the end of this report.
Performance figures for periods one year and longer are annualized.

Two medical device companies dominated returns for the quarter. On the plus side **MAKO Surgical (MAKO)** was bid for by Stryker Medical and was up 145%. **Morphosys (MPSYF)**, the German biotech company (which was the leader last quarter and up over 30%), was up another 38% this quarter. **Boeing (BA)** up 15%, **Vodafone (VOD)** up 22% and **Computer Sciences (CSC)** up 19% rounded out the top five contributors.

**Biolase (BIOL)** continued for the second quarter in a row to come back from its lofty heights after being up 100% in Q1. We think the stock will return to investor favor. There were no disappointments from an enterprise perspective in the companies we hold. In an otherwise solid quarter **Verizon (VZ)**, **CREE (CREE), Vertex Pharmaceuticals (VRTX)** and **IPG Photonics (IPGP)** were all down between 5% and 7%.

## PORTFOLIO ACTIVITY

We invest in enterprises, buying the business if you will, and believe the portfolio is well positioned to benefit from a recovering economy as we go forward. We made no changes to the portfolio this quarter.

## PORTFOLIO COMMENTARY

Investing requires formulating “guesstimates” and integrating them into a hypothesis as to what the future will be. Politics and regulatory concerns are one of the vagaries factored into these considerations.

In trying to factor “Washington” into investing, hark back to the scene in “The Sound of Music” where the nuns are deliberating over how to deal with a recent addition to the convent, who seems to be on a different page. “How do you solve a problem like Maria” needs to be modified to, “How do you invest with a problem like Washington?” As investors, we don’t get into comparing the charming and delightful Julie Andrews to members of Congress or become involved in formulating solutions.

As intractable and thorny this issue we have created for ourselves may be, we believe that it will not be the undoing of our economic recovery or markets. However, political wrangling is damaging to our economy, which remains in a slow mid-cycle expansion amid improvements in employment and manufacturing, a steady corporate sector, and a somewhat benign credit and inflation environment. Kicking the can down the road addressing critical decisions to 2014 only extends the uncertainty. This will continue to be a wet blanket on corporations and a hindrance to economic growth possibly for the foreseeable future. One of our favorite adages is “successful investing is a marathon not a sprint” and Washington has added a few hills to our race.

Investing with a problem like Washington in mind is the reason we have built a higher yield into our portfolios than many other growth managers. We will continue to focus on companies with the best prospects that have the capacity to provide outstanding returns over the long-term. We invest factoring in the stock's potential total return. That is why many of the companies in our portfolio pay dividends. We believe yield helps mitigate the market's short-term volatility impact on our portfolio and enhances the total return. Historically, dividends are a helpful way to soften vicissitudes of a volatile market and of an economic downturn. Dividends help managements send a clear message to shareholders about a company's prospects, performance, and fundamentals. Dividends force managements to allocate capital wisely.

Companies in the S&P 500 are on track to earn more than $1 trillion this year. Yet, even with companies paying out 32% of their earnings in dividends, above the average for the past 10 years, the S&P 500 yield is around 2%, less than half the historical yield of 4.4%.

Dividends have helped to boost portfolios' performance. According to investment firm Blackrock, over a 76 year period ending in 2011, the S&P 500 averaged a little over a 10% annual return. Dividend stocks in the S&P in that period returned 12.3%, while non-dividend payers returned 8.96%.

From 1990 to 2010, the S&P 500 returned 394%. Ibbotson Associates say 43% of that total return came from dividends, while 57% came from rising stock prices. Many fast growing speculative companies don't pay dividends because they are preserving their capital for internal growth. But for more mature growth stocks, dividends send a clear, powerful message about future prospects and performance. A company's willingness and ability to pay steady dividends provides clues about its fundamentals.

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To best achieve a better overall risk adjusted rate of return we invest in a combination of large growth companies and younger more stable rapidly growing and generally intellectual property-rich scientifically-focused growth companies. In our Growth Equity offering, 55% of the holdings pay a dividend and 24% of the portfolio is comprised of companies paying essentially a 3% yield. We like the long term prospects of the dividend-paying telecoms in our portfolios - Verizon, AT&T, and Vodafone - not only because they are direct beneficiaries of the booming cell phone/smartphone phenomenon, but also because they pay hefty dividends, ranging from 4 to over 5%. We regard them as bond equivalents with potential for increased payout as well as market appreciation - and a great way to invest in the wireless revolution. Other high quality names in the portfolios with at least 3% yields include: Intel (3.9%), General Electric (3.2%), Caterpillar and Cisco Systems (2.9%). We believe these companies are not only solid fundamental entities, but also have high, growing payouts that are well-protected for the long term.

## MARKET COMMENTARY

A view of the world economies from a scanning satellite would show slow improvement in Europe, the same for Japan, a slowing in the steaming pace of China, a slowing in the exporting nations of Latin America, and encouraging persistence in the tempered pace of America and of Canada. This all condenses to a genre of slow improvement that is supportive for shares. Refractive unemployment of persons and of facilities continues to keep central banks in stimulative modes, and acts to obviate the sponsoring of overreaching viewpoints and of excessive activities nearly everywhere. Endemic to the progress underway, there is little or no need for more help from governments (and for that matter not very much is), within the powers of governments to boost activity without fostering counter forces. The key to progress is seen in the supportive interrelationships of commerce throughout the normal course of activity among societies, as by-and-large is taking place.

As always, the health and disposition of the stock market must be defined within the context of the emotional waves that emanate from the political background. As the tragic violence in Syria sent menacing clouds beyond its borders casting shadows across financial markets, the coincidental intensification of tensions that centered upon Iran’s nuclear weaponry roiled national interrelationships through mid-summer weeks. The combined stress of such foreboding consequences had the effect of pressing Russia, the United States and other nations into cooperative dialogue which were fortuitously (and fortunately) timed for the eve of the United Nations’ Assembly meetings in New York City. The resilience of the American stock market in the midst of Washington deliberations that proceeded to the very edge of direct military involvement (that surveys showed to be unsupported by a large majority of citizens) seems to imply there is latent, as well as kinetic, financial energy underpinning the upward market trend.

Also out of the political background of events, take special note of Mrs. Markel’s victory for its granting (as election wins do) increased degrees of freedom, and of the propitious timing in the context of German leadership for greater Europe. This gives a breeze of good hope to refresh unity of spirit throughout Europe, and beyond.

Improvements have become self-regenerative. The down cycle patterns of yesteryears no longer dominate; that is, with one looming exception. The automobile industry, which has done so well around the world, has attained a rate of output that seems unsustainable. We suspect that this very large industry will give the most conspicuous appearance of slowing as progress proceeds beyond immediate months.

After the persistent increase in America's economic activity, after so much recent-year gain in corporate earnings (especially by larger corporations), and after so much advance in equity prices, the word slow is an appropriate description for months ahead. Corporate profits are at very satisfactory levels. Accordingly, we continue to emphasize full investment positions, giving emphasis to quality, and continuing with due emphasis upon current return through dividend payments. Many observers and wannabe sages still speak in traditional literary phraseology of cycles as though a downturn is imminent, unaware that most modern economies have outgrown such cycle patterns. In contrast, we do not visualize a down cycle that would impose on equity valuations in immediate months.

All things considered, circumstances continue to be propitious for selecting shares of thriving industries.

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The Growth Equity composite was created on January 1, 2003, representing actual separately managed taxable and tax-exempt equity client portfolios managed on a discretionary basis according to Princeton's Growth Equity investment strategy without client restrictions for the period(s) indicated.
Performance results are calculated internally using Advent portfolio accounting software. Accounts are included in each composite and its performance at the beginning of the first full calendar month in which the account is fully reflective of the investment strategy. Performance and index valuations and calculations include cash and cash equivalents and also include the reinvestment of dividends, interest and other earnings and are computed and stated in US dollars. All performance figures for periods one year and greater are annualized. Returns are weighted for the size of each underlying account. Net returns are reported net of management fees and commissions. A client's return will be reduced by our advisory fees and other expenses a client may incur in the management of the client's portfolio. Our advisory fees are disclosed in our Form ADV 2A. Also, there is a compounding effect of advisory fees over time on the value of a client's portfolio.
The **S&P 500 Index** is an unmanaged index generally considered to be representative of the US stock market as a whole.
The **Russell 3000 Growth Index** is an unmanaged index that measures the performance of the broad growth segment of the US equity universe. These indices are unmanaged and include the reinvestment of dividends and earnings. Individuals cannot invest directly in any of these indices.
Performance results, and advisory fees, for individual client portfolios will vary due to the timing of investments, additions/withdrawals of funds, diversification guidelines, length of relationship, and size of positions, among other reasons. For additional information about the performance of the composite or our current fee schedules, please contact Princeton Capital Management.
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