

YOUNG ENTERPRISE SHARES (YES) REVIEW

Third Quarter 2014

PERFORMANCE COMMENTARY

In recent weeks, investors have experienced yet another anxiety spell such as the market recurrently has talked itself into. These have all been spuriously irrespective of supportive background factors, such as inveterate flows of funds into America's capital market and a consistently improving economy. For this last anxiety attack — it should be acknowledged — increased credibility was derived from the issues in Eastern Europe and in the nations east of the Mediterranean. These are much more than mere distractions, being open-ended in their potential outcomes and influences.

Weakness in shares of young companies did not precede this most recent market setback, nor did these in the aggregate add to the depth of the retreat. The evidence of bargain hunting in selected young enterprises is unmistakable in renewed regard.

The market has now provided price changes in equity common shares that show an incipient major shift in interest toward mid-sized and smaller companies. That is, those that have refreshingly new products that encourage growth of revenues. This evidence appears after a decade in which young companies — categorically speaking — comprised a sector of the market that was out of favor, and hyper responsive to any disappointments, as well as to general external pressures. (There were a few exceptions in the well-sponsored and well-publicized IPOs in the realm of communications and data management).

With such preceding disregard and fear for the enterprise risk in young companies, it was difficult to attain a gratifying rate of return. Focused indices reveal this long-run relative disparity. There were a few notable exceptions in recent months, such as shares of Apple, Alibaba and biotechnology companies, again having come into favor. The gain in price of biotechs in recent months seems to give little heed to the problems of pre-commercial biotechnology entities, which must endure so long a development stage then clinical trials, and finally into the real world for which the adoption rate usually requires detailed education and encouragement.

There is reason to expect a lasting improvement of regard, as recently evident, for young companies having good products that have become usefully applied as intended. Revenues for such companies are generated by the products themselves. This thesis carries, and is supported by, the simple fact that in an economy that is growing more slowly, it is wise to be in vessels with superior propulsion systems. We think the general (or exogenous) reasons for this evident improvement in investor interest for young companies to be well supported by both relative alternative valuations and by an improving economy.

In uncertain or perilous times, it is of increased importance to emphasize well-managed enterprises. Let those managements deliver the investment results hoped for. This is ever a well-

demonstrated principle that commonly provides approximately as expected. For younger companies, keep faith, relying upon the functionalities of their specific products to drive investment results.

PORTFOLIO COMMENTARY

TriQuint Semiconductor (TQNT) was the best performer rising 21% on the strength of positive earning guidance, optimism over continued success as a supplier to Apple and synergies from its merger with RF Micro Devices. **Vertex's (VRTX)** stock (up 19%), continued its momentum from a very strong (45%) 2Q on a very positive outlook for its cystic fibrosis drug, Kalydeco. An improving outlook for the gallium arsenide semiconductor substrate business pushed **AXT Inc. (AXTI)** 14% higher. **Biolase (BIOL)** rose 13% as speculators pondered as investors digested the technology rich company's ebbs and tides in corporate governance.

Cytori Therapeutics (CYTX) fell 72% on concerns of progress in its cardiovascular drug trials and possible financing needs. **Maxwell Technologies (MXWL)**, a manufacturer of energy storage devices, declined 42% on a shortfall in revenues. Biotech company **Sangamo BioSciences (SGMO)**, having rallied roughly 30% in late June, gave up its gains and was down 29% in the quarter. The stock suffered from investor indifference, not enterprise concerns. Continuing its slump since March, **Solazyme (SZYM)** was off 37% on continuing concerns over manufacturing efficiencies.

PORTFOLIO ACTIVITY

During the quarter there was limited activity with only one new position and one addition and one reduction to existing positions.

We added to our holding in **Mesoblast Limited (MBLTY)**. It is a leading Australian biotechnology company with multiple stem cell products in development addressing a broad array of disorders. Included are congestive heart failure, Crohn's disease, diabetes, arthritis and bone marrow transplants, among many others. It is one of the most advanced companies in regenerative medicine with five products in phase three trials. With the stock down roughly 50% from its two year high, MBLTY provides significant upside potential.

A new position was taken in **Newport Corporation (NEWP)**. The firm is probably the great granddad of companies in the YES portfolio. Founded in 1938 and located in Irvine, California, the company produces photonic, laser, and optics products for the global scientific research, defense, semiconductor, life science and industrial markets. Given its broad product array, diverse customer base, and more moderate earnings growth, NEWP is a more conservative holding. It sells at only 15X earnings, a little over book value and approximately 2X sales and should provide more consistent stable growth.

On the reduction side, we cut back on our position in **Morphosys (MPSYF)**. A German biotech company with 20 therapeutic antibody products in trial, the company has one of the industries richest research portfolios (90 drugs). Its impressive list of strategic partners bodes well for the

commercialization of its efforts. However, with the stock approaching \$70, from under \$20 in 2012, it seemed prudent to trim the position.

MARKET COMMENTARY

After advancing for over five years, there is a supposition among forecasters that the bull market has reached maturity and warnings of its imminent demise are more common. The concerned base their fears on a number of factors, including geopolitical discord, a faltering global economy, threat of rapidly rising US interest rates, and an impending, dramatic decline in corporate profitability.

With operating margins at a cyclical high of nearly 9.5% and tepid top line revenue growth, the “bears” feel a reversion something closer to the mean margin of 6% is on the horizon; a scenario not friendly to the economy or the equity market. However, an analysis of the major cost components determining corporate profitability does not affirm the fears of an imminent, deleterious impact on margins.

1. Labor: In spite of the recent drop in the unemployment rate, wage inflation pressures do not appear to be threatening. Presently, the interaction between the weakness of labor unions, economic globalization, domestic underemployment and innovation/productivity improvements provides headwinds to rapid wage rate acceleration.
2. Raw Materials: The combination of sub-par global growth and new supplies (especially US energy) should keep commodity prices well contained.
3. Interest Cost: The outlook for moderately rising interest rates combined with a lengthening of the duration of debt on corporate balance sheets should mitigate any sharp cost escalation.
4. Taxes: While there is growing pressure from the government on corporate tax abuses, there is a general understanding that the relatively high US corporate tax rate is non-competitive on a global basis. So, dramatic tax code changes are not currently anticipated. Eventual reform would not reduce corporate payments and, most likely, would be accretive to the Treasury; but not meaningfully so.

Over the next few years, prospects for the trends in the “costs of doing business” do not appear to be worrisome. With stable profit margins and moderately growing revenues, the outlook is for a continuation of a historically high level of absolute profit generation. This will have a very positive impact on American corporations:

1. The building excess cash flows can be employed in share buy backs, increased dividends, and merger and acquisition activities.
2. Already strong balance sheets can be fortified.
3. An acceleration of business expansion can occur through increased capital spending and new hiring.

4. The anticipated ongoing decline in energy prices, as the result of the dramatic growth in US energy production/conservation, can continue to exert an increasingly positive influence on our inflation, growth and employment, balance of trade, and global manufacturing competitiveness.

The simulative effects of these financial and operating improvements bode well for the overall economy and stock market. Thus, we maintain our positive stance on the US equities.



DISCLOSURES:

Princeton Capital Management, Inc., ("Princeton") is an independent investment management firm registered with the U.S. Securities and Exchange Commission based in Princeton, NJ.

The Young Enterprise Shares (YES) composite was created on January 1, 1993, representing actual separately managed taxable and tax-exempt equity client portfolios managed according to Princeton's YES strategy on a discretionary basis primarily in the equities of smaller-capitalization growth companies 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. As an example, the deduction of investment management fees would reduce the annualized return for the five years ended December 2013 from 22.0% to 20.4%. Actual investment advisory fees incurred by clients may vary.

The **S&P 500 Index** is an unmanaged index generally considered to be representative of the US stock market as a whole.

The **Russell MicroCap Growth Index** is an unmanaged index that measures the performance of the microcap 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.

Any securities listed in this material do not represent all the investments purchased, sold or recommended for client accounts by our Firm and may only be a representative list. Our investments and recommendations may and do change from time to time or at any time. Individual portfolios may have different characteristics due to a portfolio's start date, particular client needs, portfolio manager preferences, or other factors. The securities listed have been selected on an objective and non-performance based criteria. One should not assume that an investment in any of the listed securities was or will be profitable or equal the performance of the securities listed. Princeton offers to provide a list of all recommendations for the prior one year period on request.

The stocks named as the top or bottom contributors to performance for the period are based on a model portfolio structured to represent the YES composite. 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

PAST PERFORMANCE SHOULD NOT BE CONSTRUED AS A GUARANTEE OF FUTURE PERFORMANCE

Princeton Capital Management claims compliance with the Global Investment Performance Standards (GIPS®).