YOUNG ENTERPRISE SHARES (YES) REVIEW

Second Quarter 2016

LIGHT AT THE END OF THE CHUNNEL

PERFORMANCE COMMENTARY

After a very volatile first quarter with monthly changes in the S&P 500 ranging from +6.8% to -5.0%, the first eleven weeks of the second quarter were distinctive in their ennui. The market began the quarter at 2060 and until June 23rd traded in a narrow range of 2119 (+3%) to 2040 (-1%). During the quarter, complacency on the economy set in with the peak of the inventory correction behind and prospects for better second half growth ahead. Rather than repulsed, investors seemed to be oddly entertained by the antics on the domestic political scene. Global and domestic terrorism continued unabated, but the financial markets were inured to its brutality. That was until June 23.

With the vote by the UK to leave the EU, chaos reigned. British political leaders were ousted with no apparent succession, economic pundits cast dire forecasts on the outlook for the UK, EU, and US, and around the world interest rates, currencies and stock markets were epileptic. The initial two-day downdraft in the US stock market was -5.4%, providing market historians with ample fodder for dire forecasts. As cooler heads prevailed, the optimists, armed with predictions of new and necessary monetary easing in Europe/UK and potential delays in rate hikes in the US, overcame the pessimists and by quarter end the market had regained almost all of its earlier losses. By June 30, the rally brought the S&P 500 Total Return up 2.5% for the quarter, 3.8% year-to-date and within a few percentage points of its all-time high.

The rather unimpressive gains for the overall market disguised some rather significant internal dispersions and a strong risk-averse bias. For the quarter, defensive stocks rose 5%, while cyclicals were up 2%. For the six months, the gap was even wider at +7% versus +1%. For the six months, value outpaced growth by +6% to +2% and the market favored large-cap (+4%) to small-cap (+2%). Individual industry returns were even wider. For the second quarter, telecommunication and utilities were up 8% and energy +11%. The only negative area was information technology at -2%. Year-to-date, leadership was the same with telecommunications +24%, utilities +22%, and energy +14%. At 0%, technology was the sole industry showing no gain.

	Periods Ending June 30, 2016						
	QTD	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**7 Yrs**	**10 Yrs**
Young Enterprise Shares (YES) Composite - GROSS	**8.4**	**0.5**	**-10.8**	**3.9**	**-0.1**	**11.5**	**4.8**
Young Enterprise Shares (YES) Composite - NET	8.0	-0.2	-12.0	2.5	-1.5	10.0	3.4
S&P 500 Total Return Index	2.5	3.8	4.0	11.7	12.1	14.9	7.4
Russell Microcap Growth Total Return Index	3.2	-5.9	-18.5	5.7	7.5	12.7	4.8

Performance figures for periods one year and longer are annualized.

PORTFOLIO COMMENTARY

There was more activity in the portfolio than normal in this quarter. We lost two long time holdings and a recent purchase to acquisitions. Thermo Fischer Scientific acquired FEI Corp (FEIC) in a cash bid of $107 per share. We invested in FEIC in 2010 for $17 per share. Investing in scientifically driven small companies does not always pan out as expected. We also invested in Hansen Medical in 2010. However, we paid $14 per share and the founder of the company (who subsequently left the company) bought the company along with a private investment group for $4 in cash. We obviously believed the technology to be worth significantly more than the purchase price.

The value of scientific discovery can often take a long time to become recognized, however sometimes it can be realized quickly. We bought Celator Pharmaceuticals (CPXX) in early April (see description of new purchases below) at $14 and Jazz Pharmaceuticals bought the company for $30 a share in cash at the end of May. Again, we believed that over time the company was worth more.

We also sold our position in Morphosys AG. They have changed their business model from more of a licensing-their-drug-discovery-for-others-to-develop approach to a more develop-internally approach. We think while this may be more profitable at the end of the day, it entails more risk and a longer path to reward. We invested the proceeds in Celator Pharmaceuticals and Incyte Corporation (INCY).

Incyte (INCY) focuses on developing therapeutics for treating cancer and is past trials with a product on the market to treat blood and bone marrow cancer. They also have drugs in Phase II trials addressing diabetes, rheumatoid arthritis, and psoriasis. A low $70's entry point seemed reasonable value considering existing revenue stream, a strong pipeline of potential new drugs and the stock had retreated from a 52-week high of $130.

Celator Pharmaceuticals, Inc. (CPXX) is an oncology-focused biopharmaceutical company that is engaged in combination therapy to improve patient outcomes in cancer. Their technology platform enables the rational design and rapid evaluation of optimized combinations of anti-cancer drugs. It incorporates traditional chemotherapies as well as molecularly targeted agents to deliver enhanced anti-cancer activity. They identify the most effective synergistic molar ratio of the drugs being combined *in vitro*, and fix this ratio in a nano-scale drug delivery complex to maintain the optimized combination after administration and ensure exposure of this ratio to the tumor.

PORTFOLIO ACTIVITY

As mentioned in our comments on portfolio activity, three of the top performers in the quarter were due to acquisition. **Hanson Medical (HNSN)** was up almost 50%, **Celator Pharmaceuticals (CPXX)** was up almost 100% and **FEIC Corp (FEIC)** was up 22%. Two long time holdings **Universal Display (OLED)** and **AXT Corp (AXTI)** were up 25% and 29% respectively.

All too often price action of these small companies in the short run is about short term considerations. Two of the holdings that were a drag on performance this quarter were yoyo like over the last two quarters. **Mesoblast (MESO)**, a biotechnology company engaged in the development of regenerative therapeutic cell-based products, was up 51% in the March quarter. It was down 59% in this quarter after announcing a slight delay in a trial. **NeoPhotonics (NPTN)**, up 30% in the last quarter on better demand for high-speed digital signal transmission equipment, was down 32% as demand flattened a bit. **Infinera (INFN)**, another of our holdings in the same relative space, was down 32 % as well. **IPG Photonics (IPGP)** was off 17% but has been an excellent performer over time for us. The leading fiber laser manufacture's outlook was softer for a quarter or two. We believe they will continue to develop new markets for industrial laser utilization and have a bright future. Lastly **Maxwell Technologies (MXWL)** was off 11%. We believe that the Paris accords on climate change signal clear recognition that the world is going from fossil fuels to electricity. Maxwell is engaged in the manufacture of capacitors which provide energy storage and power delivery solutions to the transportation, information technology, renewable energy, and industrial electronics industries.

MARKET COMMENTARY

The Brexit vote and the success of the two non-traditional candidates (Trump and Sanders) in the US can be seen as a statement by a meaningful portion of the electorates that the current political and economic policies are not working, that new and maybe even some refurbished old ideas need to be explored.

In the aftermath of the Brexit vote, there have been few if any observers who have felt anything but deep concern; concern over the health of the already fragile global economic and political systems, especially those of Europe. No forecaster has raised the possibility of better future economic growth or pondered a more stable political environment in the Western developed world.

The titles of two recent reports from the macroeconomic research firm Strategas cleverly address some of the underlying issues. "Revenge ON The Nerds" by Daniel Clifton proposed that the middle class, after years of frustration over the profoundly ineffectual policies of the elite intellectual ruling class (both left and right), is rebelling. In "Angry Is The New Hope", Jason Trennert addresses the frustration and indignation of the populace in their elected officials. President Obama ran using the slogan of "Hope", and after eight years voters sense little progress has been made. Anger has replaced hope and many are looking for a new type of leadership to restore economic growth.

However, if one steps back from the current anxiety and looks a bit longer term, there may be some very positive repercussions from today's and tomorrow's likely dislocations.

In high school social studies, students get their first taste of economics, "The Economic Triangle," which, because of its simplicity, does not bear the name of a noted Nobel economist. It depicts an economy consisting of three participants: Government, Business, and Labor. The three are supposed to cooperate with "constructive" tension providing for growth. It has been the cornerstone for the unrivaled success of the American economy: the Government's building of the railroads, highway system and electrical grid, while implementing social security, Medicare and Medicaid; Business with scientific discoveries, manufacturing innovations and capital investments; Labor with a strong work ethic and mobility. All three worked to dramatically improve the US's standard of living over the past decades. So, what has gone wrong with the "Triangle" in recent years? Why are Europe and the US stuck with subpar growth and seemingly having only "unconventional" monetary policies as their elixirs?

In the natural and social sciences, constituents have defined life cycles. In economics, they are often depicted by an S Curve, with rapid growth at the embryonic stage, slowing over time to eventual death. Might it be that the "Economic Triangle" is in the later stages of its life? That the current efforts to stimulate growth will only get unsatisfactory, diminished returns? That the "Triangle's" constructive tension has turned destructive? That the three participants need to reset their priorities and egocentric behaviors?

Does Government need to be smaller and/or more efficient, be more responsive to the needs of the middle class majority, and become less intrusive? Does Labor need to be more responsible for its own education, to rekindle its work ethic, to become more mobile? Does Business need to stop hiding behind the four worst words in capitalism (maximization of shareholder wealth), become more sensitive to income inequality, have greater respect for the environment, and rethink its tax responsibilities?

The pessimists contend that the rising populist desire for change/inclusion will undermine the current somewhat fragile political/economic stability. This heightened uncertainty is, in their eyes, unacceptable and the status quo is preferable. The voters are expressing a different opinion.

The question is where, over time, will the beginnings of this populace movement lead? The system is at an important fork in the road. If Government and Business selfishly turn a blind eye to change, then social unrest and ugly nationalism could follow. If, however, priorities are reset and the constructive tension is restored, then future economic activity can return to its prior rates of growth. If the reformation begins under the tutelage of responsible leaders, it will be positively received by investors and expressed by a higher stock market.

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