CORE EQUITY PORTFOLIO REVIEW

First Quarter 2009

Our Core Equity strategy once again provided protection in an extremely inhospitable environment, in line with its conservative, dual objective of wealth creation and preservation. We hope the following commentary sheds light on what we're thinking and doing in this environment.

	Periods Ending March 31, 2009				
	Quarter	1 Yr	3 Yrs	5 Yrs	10 Yrs
PCM Core Equity Composite	**-8.7%**	**-28.0%**	**-6.7%**	**1.1%**	**4.5%**
S&P 500 Index	*-10.9%*	*-38.0%*	*-13.1%*	*-4.8%*	*-3.1%*

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

MARKET COMMENTARY – "And the stock looks really cheap here"

Ever heard this phrase from the talking heads on CNBC? Or read it in pages of a brokerage report? Ever find yourself muttering "you said that when the stock price was twice as high six months ago"? Lately we've been muttering quite a bit ourselves, having used the 'C-word' when describing our purchase of a few stocks last summer, only to see prices drop significantly lower and render hollow our opinion of cheapness. What exactly does 'cheap' mean? You have every right to ask.

Well, It Depends …

In my undergraduate days (c. early 1980's) a well regarded investor of the time articulated his rules for defining the cheapness of stock prices by referencing *Security Analysis*, by Graham, Dodd and Cottle. In this classic work, the authors tabulate what amounts to a formula for fairly valuing a common stock. We will spare you the details, but essentially the authors created a table of multipliers that could be applied to current earnings of a company, with higher multipliers (or earnings multiples) being correlated to higher expected growth rates. This was simply a short-hand method of applying classic valuation techniques such as the dividend discount model. I was sufficiently intrigued to purchase this great book, and after verifying the managers' observations decided that the book's valuation methods were the way to professional prosperity.

Only a few years later, a second famous manager quoted the same authors, but this time offered valuation guidelines quite different from those of the first manager. The second manager only bought stocks that are "(a) selling below liquid-asset values; (b) are apparently in no danger of dissipating these assets; and (c) have formerly shown a large earning power on the market price." These guidelines create "a class of investment bargains" according to the authors. I was dumbfounded. These two methods are quite different and lead to quite different groups of stocks to consider for purchase, depending upon the market environment. Did I miss a chapter?

It turns out the second set of guidelines came from the famous book's first edition of 1934, while the second was from a later 1961 edition. How, I wondered, could such different methods to gauge cheapness be espoused by the same authority – and both be used successfully? The answer is fairly straightforward, and raises an important lesson now being learned by an entirely new generation of investors.

Optimism and Pessimism in the Market

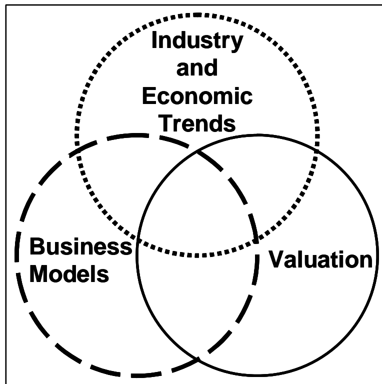
The stock market, as it passes through its cycles of optimism and pessimism, will sometimes anticipate a very prosperous future, and some times not. We find the market's perception of the current investment horizon is directly proportional to the returns earned over the recent past. For example, in 1999, after several stellar years of stock returns, especially by those companies related in any way to the Internet, the market expected unsustainably high future rates of growth over a very long time period, applying very large multipliers of current earnings (certainly larger than those espoused by Mr. Graham and the first manager). On the other hand, in

times of great economic stress, as in the 1930's, the market barely looked beyond the next week, as the first edition of the *Security Analysis* points out. During such times of economic duress, the market values many companies' common stocks below their net current asset value (the sum of the current assets minus the sum of the current liabilities). In this scenario, all the companies' fixed assets are ignored, because, in the middle of a depression, who wants fixed assets?

As we mentioned in our review of the fourth quarter of last year ("The Secular and the Intermediate"), intermediate events such as economic cycles, wars, financial panics, etc., can make a mockery of attempts at valuing common stocks. Yet we, including others, have found from study that in general, the market takes about five to ten years to work from one extreme to another. Consider what we have seen it in the past nine years: at the beginning of 2000, the market as measured by the S&P 500 was expecting impossible rates of growth over impossibly long periods of time, whereas at the end of 2008, the market was far more skeptical, foreseeing a murky investment horizon of only a few years.

A Necessary, Though Imperfect Exercise

Why bother with valuation? If the market prices its offerings at such wide variances, how can an investor calculate any usable range of values? As we have said above, the market does tend to regress to a mean, on average discounting earnings out about seven to ten years. Using this time frame in an analyst's calculations tends to provide a usable range of values, though requires patience when it comes to entering or exiting stocks based on such valuation calculations alone.



The graphic to the left is one we use to illustrate Princeton Capital's multi-faceted approach to analyzing investment ideas. Valuation is one, but not the only, component used to evaluate our purchase candidates. Our valuation work creates a range of values that reflects optimistic assumptions of growth and profitability as well as pessimistic assumptions. Of the sixty-three stocks we currently track for inclusion or potential inclusion in our Core Equity strategy, twelve have current prices more than twenty percent **below** the bottom end of the range we set in early 2008, and some significantly so. Unsurprisingly, these twelve have a whiff of actual or perceived risk to them (cyclical end-markets; narrow geographic end-markets; high operating leverage; potential credit challenges) that helped to drive down their prices. Though we are disappointed with our valuation estimates on these twelve, we see no reason to abandon the exercise. Our valuation work helped us avoid some major down moves in other potential holdings that had attractive business models and should enjoy, in our opinion, long term above-average demand, but were too expensive in 2007 and 2008. We strongly believe that using all three facets of our approach helps us in the long run by creating multiple perspectives on potential investments. As shown by the market's incredible downward move in the past eighteen months, you need more than a one-legged stool to stand on.

PORTFOLIO COMMENTARY

Turnover in the portfolio during the first quarter was minimal. One new name in the portfolio is a clear beneficiary of an unfolding trend: the return to preeminence in the coming years of North America's farm sector. Like others, we believe the rising food consumption in the world will lead to a tail wind for those industries meant to plant, grow, harvest and transport basic food commodities from North American to the rest of the world. Also, we are optimistic about other farm areas outside of North America, including Brazil. One farm-related company we have had our eye on for a while is **Monsanto** (MON), the seed company based in St. Louis. Besides the demand tail wind, we have long been attracted to the strength of Monsanto's business model. The company uses biotechnology to alter seed traits, yielding greater efficiencies for farmers. For example,

Monsanto has developed seed traits that enhance the efficacy of the company's herbicides and pesticides. The company has also developed disease resistant traits and is ready to unveil traits allowing for less water consumption. All this intellectual property makes Monsanto look like a pharmaceutical company of yore: it has great margins and minor fixed capital requirements, although research and development costs are obviously large. Though it has had trend and business model factors in its favor for some time, Monsanto's stock price was too expensive until this past December and January. In January of this year, we made an initial purchase at a price in the low 70's.

On the sell side, towards the end of the first quarter we liquidated our position in **Eastman Kodak** (EK)…at quite a loss. If you are interested in our reasons for its purchase, look only to last quarter's letter where we discussed such. In sum, we knew when we purchased Kodak last summer that it was a company in transition, and given the massive restructuring and losses generated, it had been a tremendous capital consumer. However, we believed Kodak in the future would be a capital producer, that is, a cash generator. We also believed that Kodak had assets that, in a pinch, would fetch at least the price we paid for the stock. The credit debacle and deep recession rendered most of our assumptions about Kodak less than useful. In the fourth quarter, Kodak became a cash consumer (again) and it does not appear the company will be cash flow positive until the fourth quarter of this year. What led us to selling it however is its prospects for 2010. Because of a likely convertible bond put, Kodak will need to raise funds in 2010 unless the worldwide economy is clipping along at a decent pace allowing Kodak to generate meaningful cash flow. If the economy does not cooperate, there is some risk to Kodak as an ongoing entity. At Princeton Capital, we offer several investment strategies that can tolerate the risk/reward tradeoff from companies with enterprise risk, that is, the risk the company may become worthless. Core Equity, a more conservative strategy that balances wealth creation with wealth preservation, is not one of them. In Core Equity portfolios we want to minimize downside volatility, and thus prefer to focus on companies where the risk is valuation-based rather than enterprise-based. At Princeton Capital, we are not big on too many constraints, but keeping Core Equity free of companies that might not make it is one of them.

Given the discussion above concerning Princeton Capital's three-pronged analytical approach, you may wonder what we saw on the business model or industry trend side. We must admit that it was the apparent attractive valuation that led us to minimize Kodak's less than stellar business model or the cyclical tailwind that in mid-2008 quickly became a headwind. It is a lesson, yet again, to continuously consider all three analytical perspectives when evaluating investment prospects as well as current holdings.

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 PCM's conservative, equity oriented investment strategy. Prior to 1/1/09 this strategy and its composite were marketed as PCM'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. Prior to 1/1/00 the composite excluded taxable accounts. From 1/1/98 through 12/31/99 the composite included only those accounts between $500,000 and $10,000,000 in size. 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 U.S. dollars. All performance figures for periods one year and greater 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. The Balanced Index is a blend of the S&P 500 Index (60%) and the Lehman Government/Corporate Bond Index (40%). Additional information regarding policies for calculating and reporting returns is available upon request. A client's returns may be reduced by other expenses incurred in the management of the client's portfolio. PAST PERFORMANCE SHOULD NOT BE CONSTRUED AS A GUARANTEE OF FUTURE PERFORMANCE.