CORE EQUITY PORTFOLIO REVIEW

Second Quarter 2009

The stock market of second quarter 2009 was a remarkable mirror of the previous quarter. The S&P 500's torrid second quarter 15% gain reversed the first quarter's 10% dive. Large, financially sound enterprises, diversified by product offering and geographic scope were favored in the first quarter while small and less diverse enterprises beat large and safe ones in the second. Despite this dramatic volatility, most U.S. equity indexes are up modestly year-to-date and Core Equity portfolios reflect similar performance. For our long term Core Equity clients, the strategy continues to outperform by several hundred basis points for the one, three, five, seven and ten year periods through June 30th.

	Periods Ending June 30, 2009					
	Quarter	Year-to-date	1 Yr	3 Yrs	5 Yrs	10 Yrs
PCM Core Equity Composite	**12.2%**	**2.4%**	**-21.0%**	**-1.4%**	**3.2%**	**5.0%**
S&P 500 Index	*15.9%*	*3.3%*	*-26.2%*	*-8.2%*	*-2.3%*	*-2.2%*

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

For the second quarter alone, the conservative nature of the Core Equity strategy served to mute performance, as we would expect in a 'pistol hot' market. How so? Our Core Equity investment strategy seeks to outperform a standard market benchmark such as the S&P 500 over a three-to-five year period, and provide downside protection in shorter periods such as a year. We were defensively positioned in 2008 and clients with us for the entire year benefited from this approach. As 2009 unfolded, we began adding companies with more growth-oriented profiles to the portfolio for the simple fact that by January and February the valuations of such companies as **Monsanto (MON)**, **Adobe (ADBE)**, and a smaller company, **WebSense (WBSN)**, became very attractive. As the markets rebounded in March, April and May, we began to slow our purchases of such stocks as such actions became less attractive. Most Core Equity portfolios remain a bit on the defensive side, with some cash and some of the defensive names we favored from early 2008 remaining.

In our comments that follow we will review, as is our custom, some of the names that contributed, both positively and negatively, to performance. And, in our Market Commentary section, we will turn our gaze forward with a topic that MIGHT have future implications for both the markets and individual portfolio holdings.

PORTFOLIO COMMENTARY

In reviewing the companies that have helped or hurt the performance of our Core Equity portfolios this quarter, we cannot ignore what happened in the prior quarter. As stated in our introduction, in many cases the big winners in the second quarter were those that were big losers in the first. Hence our security-specific commentary this quarter will for the most part take a year-to-date view since in the current environment one quarter's performance may have no bearing on longer term results.

A stock that has contributed positively from the beginning of the year, up 62%, is **Cerner (CERN)**, a supplier of hospital and medical office administrative software solutions to healthcare providers. Besides doing well financially during the first quarter, the company will likely be a beneficiary of the Obama Administration's emphasis on reducing aggregate healthcare costs. Reaching $60 a share towards the end of June, Cerner has crossed our threshold of fair valuation and we have thus been reducing the weight of this holding in quite a few older accounts given its appreciation. As is our norm, we have taken a tax sensitive approach to reducing this position: non-taxable portfolios such as retirement and foundation accounts saw reductions as did taxable accounts that had some short term losses elsewhere or for which the sale of Cerner was a long-term gain.

Another positive performer in the portfolios, up almost 24% year-to-date, is one that gets little respect these days: **Microsoft (MSFT)**. Like others, we have viewed Microsoft as a lumbering, slow-witted competitor being outfoxed in most major new businesses such as search advertising (e.g. Google). Microsoft executed poorly on its

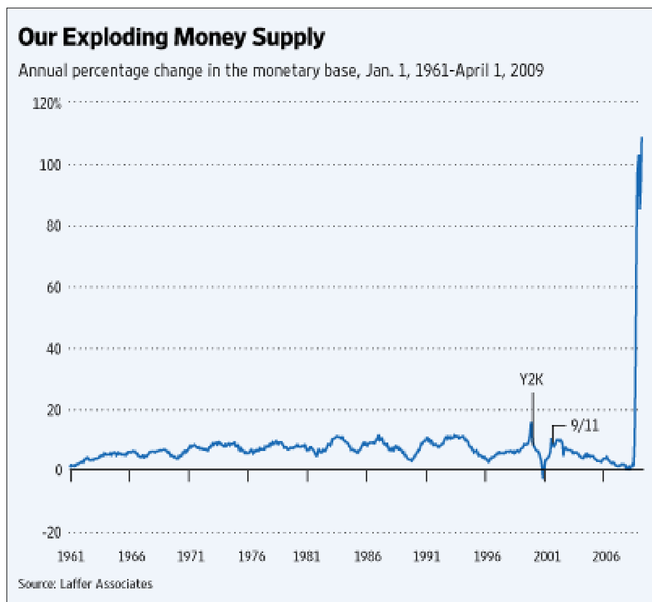
last major release of Windows, called Vista. Besides offering little of anything new, Vista was slow. As a result, many enterprises did not upgrade believing Vista was not worth the expense. However, in 2006, Microsoft moved Steve Sinofsky, the head of its Office software design team, to the Windows design team. Steve is extremely talented at organizing a very large software development team. His move to the Windows side of the business indicated to us that on the next Windows release Microsoft intended to avoid a replay of their Vista failure. Windows 7 is expected to be released this fall and we expect it to be a success. If the release does well, its success will 'move the needle' for Microsoft.

On the negative side of the performance ledger, a recent purchase got clipped right away (down about 20%) - always a disappointment. **Verisign (VRSN)** is a company in two businesses: it is the sole registrar of .com and .net domain names on the Internet and it provides security services for web site providers' financial transactions across the web. A recent Federal Appeals Court decision reversed a lower court dismissal of an anti-trust case against Verisign, a case dismissed twice by the lower court. The lower court will now again decide whether the case is worth pursuing or whether it will be dismissed on other grounds. We calculate the probability of the case going forward to be low, and the probability of a judgment against Verisign to be even lower. As we usually do in these situations, we have calculated the worst case scenario for the company, both penalties and going forward, and find that the market has more than penalized the stock price by factoring in a sure liability. Verisign's finances are in excellent shape and provide great flexibility to the company. We still believe the company has a rare privilege in the Internet economy and can continue to grow its revenues profitably even in a slow U.S. economy.

MARKET COMMENTARY - Inflation and Deflation

Of late, the topic of inflation has resurfaced in the conversations of a number of well respected investors. We've heard them discuss how they are positioning their clients' portfolios for inflation in the not-too-distant future, and describe some of the investment vehicles they are using to take advantage of the expected rise in inflation. We too would like to talk a bit about inflation and deflation – but promise not to get into demand and supply curves. We'd like to look at the issues of inflation and deflation relative to common stock selection and our particular approach to portfolio construction at Princeton Capital.

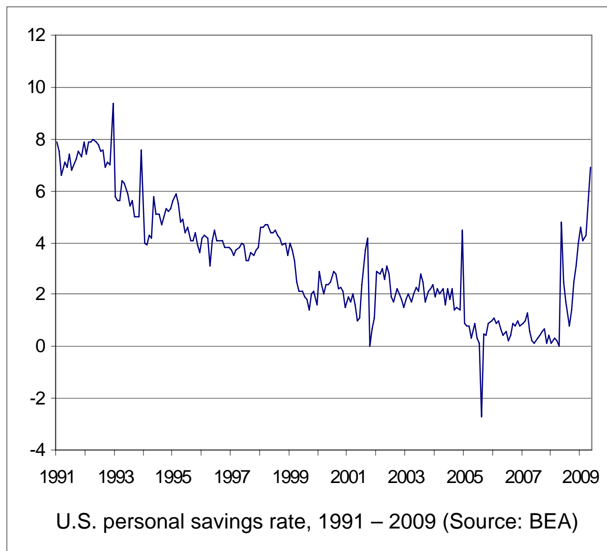
The cause for the alarm on inflation is the recent actions by the U.S. Federal Reserve and most of the central banks of developed countries to combat the markets' meltdown this past fall and winter. The textbook reaction to downward spiraling stock and bond markets is to flood the economy with liquidity (cash). The historic rise in the U.S. monetary base over the past year, depicted in the nearby chart, shows the extent to which the U.S. Federal Reserve followed this course of action. Never before has there been such a strong central bank response to a collapsing market.



Now that the crisis has apparently passed, the next issue concerns the central banks' ability to remove the excess liquidity or cash from the system. Historically, when this much cash is available, interest rates drop and the drop in rates spurs economic demand, thus leading to higher economic activity and higher incomes. Some are concerned that central banks in general and the Federal Reserve specifically will not be

able to pull back all the excess liquidity that was injected in 2008 and early 2009, and with such excess liquidity will come higher prices--inflation.

First, we agree the Fed will have a tricky time pulling back the excess cash it has injected into the system. This is not to say it is impossible, but the Fed will have to be alert to subtle signs of health in the economy so it can embark on its efforts to reverse its actions from last year. And the Fed will receive no help from the U.S. Treasury since the U.S. government needs to sell bonds to finance its enormous budget deficits at the same time the Fed will need to sell Treasury bonds to the world. Should the Fed be unable to sufficiently corral the excess liquidity, additional questions become important: 1) when will this supposed inflation hit, 2) what form will it take, and 3) how should a portfolio be positioned for protection?



U.S. personal savings rate, 1991 – 2009 (Source: BEA)

The first question may rightly be asked with an incredulous tone, for is there not a deep recession on right now? Indeed there is. A fascinating economic chart pictured at left, U.S. personal savings rates over time, helps to explain why. Post 9/11, U.S. consumers saved little and in fact in some months had 'negative savings.' In other words, as a whole, the U.S. consumer went into debt. However, the U.S. consumer's response to the recent collapse in asset prices has been a massive shift from spending to saving: from a near zero percent saving rate in early 2008 to a just registered six point nine percent rate in May of 2009. The effect on the economy cannot be understated as roughly two-thirds of the U.S. economy's income depends on consumer spending. When such a large block of spending reverses itself by nearly seven percentage points in so short a time frame, it will have a dramatic *de*flationary effect on the world economy. Given current consumer debt levels, the deflationary impact has been and can continue to be enormous, and in fact, inflation is not a problem. We believe it will take some time, at least until we see labor markets across the globe tighten and unemployment shrink, before we see both producer and consumer price indexes begin to pick up.

As economic activity does pick up, will price levels rise, and if so, how does the investor protect against such? We are not so sure inflation—if it does reappear—will take the same form that it did in the mid-1970's to early 1980's, when the Consumer Price Index was running at nearly a double-digit rate at its peak. The fall of the Berlin Wall in 1989 ushered in a truly epochal economic change in the release of hundreds of millions of people into the worldwide labor pool. As capital is mobile, we've seen a significant rise in 'offshoring' - that is, the move by developed nations to move its labor intensive industries to countries with lower wage rates. With so much labor available in the world, we doubt U.S., or European or Japanese workers for that matter, will enjoy the kind of wage increases seen in the late 70's and early 80's when companies were forced to match higher consumer prices with higher wages. It is quite possible 'inflation' will take the form of price increases in other ways such as higher import prices through the fall of the dollar, higher commodity prices, and higher asset prices in the form of hard assets such as land.

How does an investor protect their investable assets from a general decline in purchasing power if inflation does manifest itself in higher price levels? There are a couple of ways. One is to guess—and it is a guess—what input and output prices will do in the near and long term future and then buy those companies whose business takes advantage of the forecasted moves in prices. For example, if the dollar declines versus the rest of the world, one might expect a U.S. business that has dollar-priced inputs but non-dollar priced outputs to do well, such as

U.S. farmers and their agricultural products. (Most farmers' inputs are dollar-priced but their goods are easily transported to non-dollar markets for a nice spread.) Forecasting input and output prices can be done, but playing this game can be risky. The cost of being wrong is high.

A more reliable way to take advantage of a general decline in purchasing power, or at least not be hurt by inflation, is to buy the stocks of companies that have pricing power over their products or services. In other words, in the face of rising costs due to inflation, these companies can raise prices on their own goods and services. As we investigate investment opportunities through our three analytical perspectives (model, trend, and valuation), we define an attractive business model as one in which a company has a unique advantage versus its competition such that it can extract price increases without harming demand for its products. Obviously, there are limits to this. A company cannot forever raise its product or service prices without some threat that its customers will find an alternative. Adobe, Monsanto, and UPS are 2009 additions to Core Equity portfolios that are examples of companies with the ability to raise prices to offset the effects of input cost inflation.

It is easy to make predictions about economic trends but it is obviously difficult to consistently be right. As the old saying goes, "Weather forecasters make economists look good!" We are vigilant to the various threats, including inflation, being discussed and believe that it is often better to let events begin to unfold before reacting to them as opposed to formulating predictions of low probability events and constructing portfolios for such events. We have found that adhering to our strategy of picking companies with good to better-than-good business models, one feature of which is pricing flexibility, can help guard against unexpected price rises.

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. 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.

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