CORE EQUITY PORTFOLIO REVIEW

Third Quarter 2009

Wow. Second quarter's 'pistol-hot' stock market (as measured by the S&P 500 Index) continued right through the third quarter. After two fifteen percent quarters in a row, the market's year-to-date return through September is over nineteen percent. We are very pleased to report that Core Equity portfolios participated extensively in this rally without undermining their conservative profile.

	Periods Ending September 30, 2009					
	Quarter	Year-to-date	1 Yr	3 Yrs	5 Yrs	10 Yrs
PCM Core Equity Composite	**12.2%**	**14.9%**	**-6.4%**	**0.4%**	**5.9%**	**6.4%**
Equity Only Portion	*14.5%*	*18.0%*	*-9.5%*	*-1.4%*	*5.8%*	*4.7%*
S&P 500 Index	15.5%	19.3%	-6.8%	-5.4%	1.0%	-0.2%

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

As might be expected in such a strong market, virtually all stock positions generated positive returns. The real contributors in such an environment were those whose share price was up more than twenty percent since the end of June. Approximately one quarter of the names in the portfolio achieved that distinction, including one of the newest additions to the portfolio, Rovi Corp., which was up over 40%. (More on Rovi, below.) As was the case last quarter, cash and the larger, more conservative names in the portfolio, particularly the telecoms, had a dampening effect. This is not a surprise. Given the nature of the strategy, Core Equity portfolios will always retain a conservative profile for downside protection, and should therefore be expected to capture much, but not all, of an extreme market run such as what we've seen in the last six months.

PORTFOLIO COMMENTARY

In our year-end 2008 review, we suggested that Core Equity portfolio turnover in 2009 would be higher than normal given the market tumult:

> "The cascade of stock prices has created fields of opportunity. While the environment beckons us to shoot first and ask questions later, our experience tells us to follow-through on our normal investigatory process. This will take some time, but we do anticipate greater than normal turnover in the portfolios even in the short-term. There appear to be better opportunities available than some of the stocks currently owned. We will be transitioning into these over the next several months or quarters."

And this has been so. Over the past twelve months, our Core Equity portfolios have turned over about forty percent. At the beginning of 2008, we noted the market's then appetite for risky assets, including lower quality stocks, and suggested more attractive returns would be had by less risky stocks. Our portfolios were in a very conservative position at that time, holding stocks we believed had relatively good value which coincidently also had defensive characteristics. From mid-2008 into early 2009 we did indeed take advantage of opportunities where the market had blasted certain companies it perceived to be risky (e.g., Adobe, Life Technologies), and sold those that it deemed to be less risky (e.g., Amerisource Bergen, Glaxo). As we admitted in our year-end 2008 letter, we began this process a bit early in the summer of 2008. We also missed a few opportunities in 2009 as we favored 'our normal investigatory process' over 'shooting first and asking questions later.' However, we will continue to take our time moving from a very conservative profile towards selectively taking on riskier names in the portfolio. Current portfolio cash levels, which in March were over twenty percent, were under ten percent prior to the September liquidation of a few names showing signs of overvaluation. The environment remains difficult and we are cautious of taking on too much risk too quickly.

One of the new names in the portfolio is a company called **Rovi Corp. (ROVI)**. Rovi has an attractive business model, one we not often see or can purchase at a reasonable price. Rovi's primary business is owning the software that sits on both a consumer electronic device and at the service center of a local cable or satellite provider, allowing a subscriber to use the service provider's online program guide. The software facilitates the automated use of digital video recording, channel presets and other features. Rovi makes its money in two ways: it collects a royalty from consumer electronics makers (such as TiVO) each time they sell one of their units, and it collects a monthly royalty from the service provider per subscriber. Rovi's capital requirements are fairly low and its revenues are stable and growing. Given the royalty nature of the revenues, margins are quite high. Trends are also in Rovi's favor, given the foreseeable higher penetration of cable and satellite services in both Europe and developing economies. At the time of purchase in early July, Rovi was sellling for about thirteen times 2010 earnings estimates and after it's more than forty percent rise through the end of September is now selling for about seventeen times 2010 earnings estimates. Though we don't confine ourselves to comparable earnings multiples as a valuation tool, we believe Rovi is still an attractive holding despite its recent run-up.

Some of the portfolio turnover mentioned above involved **Cerner (CERN)**. As discussed last quarter, we had begun to reduce our exposure to Cerner in quite a few older accounts given its appreciation. At the end of August, Cerner's price was nearly thirty-one times estimated 2009 earnings and selling at about a twenty-three percent premium to our current target fair value. Given the rich valuation, we decided to exit the stock completely. We still consider Cerner to have an excellent business model and good growth prospects, but we will wait for a more attractive re-entry point.

MARKET OUTLOOK

Though credit is beginning to flow, it is primarily flowing to larger, public companies. Small businesses and consumers are still deleveraging. In addition, the lenders who are normally suppliers of such debt financing (the banks) are also deleveraging. This leads us to observe that an important element of an expanding economy (credit creation at the consumer/small business level) is missing and will take time to reappear, at least not before the banks themselves are ready to lend again. Until we see this, we expect there to be a drag on the economy. On the other hand, the monetary policy of the Federal Reserve is extremely expansive and the U.S. Treasury is carrying out large doses of deficit spending. If these two pillars, monetary and fiscal stimuli, can be maintained (an outcome not at all easy to predict given the current greater debate concerning the deficit spending in Washington), we should see more upside to current GDP estimates as the credit creation challenge recedes.

Though stocks prices in general have moved up quite a bit, we note that there are numerous companies we find interesting from a business model and trend perspective that continue to sell at discounts to our perception of value. Our clients can certainly expect further purchases and sales in their portfolios through the end of this year.

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