GROWTH EQUITY PORTFOLIO REVIEW

Second Quarter 2011

PERFORMANCE COMMENTARY

The second quarter of 2011 was thankfully devoid of the extreme natural and man-made upheavals and unrest that struck around the globe during the first quarter of the year. The three-month period just passed witnessed concerns about a more mundane event: slowing economic growth. We will comment on the U.S. and non-U.S. economic scene later in this report, but reactions to declining real estate prices and re-sale activity in the U.S., coupled with an unarguable slowing of growth in the faster growing economies of China, India and Brazil, lead to a sedate correction of stock prices in the U.S. markets. On the heels of the first quarter's strong 5.9% performance, the U.S. equity market (as measured by the S&P 500 Index) was up a mere 0.1%, resulting in year-to-date performance of 6.0%. Smaller U.S. stocks did not fare as well during the second quarter: The Russell 2000 Index, a measure of U.S. small company equity performance, was down 1.6% while the Russell MicroCap Index, a measure of very small U.S. company equity performance, was down 1.7%. As a result, the smaller company stocks as a whole are lagging behind their larger counterparts year-to-date.

The tepid overall performance of the markets for the three months ending June 30 masks the significant volatility within the quarter: Growth Equity portfolios were up over 4% in April and down nearly 4% in June; the more volatile Growth Equity holdings were not immune to the market's mid-May to late-June flight from riskier stocks. The quarter's final tally would have been lower had it not been for the portfolio's 3+% rally in the last four days of June.

	Periods Ending June 30, 2011					
	Quarter	Year-to-date	1 Year	3 Years	5 Years	10 Years
Growth Equity Composite – NET	**2.6%**	**5.8%**	**32.7%**	**6.3%**	**7.8%**	**8.1%**
Russell 3000 Growth Index	0.6%	7.0%	35.7%	5.3%	5.4%	2.4%
S&P 500 Index	0.1%	6.0%	30.7%	3.3%	2.9%	2.7%

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

As detailed in the table above, Growth Equity had a reasonable gain for the full second quarter, and performed ahead of both the S&P's 0.1% return and the 0.6% showing for the Russell 3000 Growth Index (a proxy for growth stocks of all capitalizations). **Mako Surgical (MAKO)** and **IPG Photonics (IPGP)**, both in the list of top five contributors last quarter, were the clear winners this period along with **Seattle Genetics (SGEN)**. All three posted share price gains of just over 30%. **Websense (WBSN)** and **BioLase Technology (BLTI)** round out the top five contributors due to strong share price gains (13% and nearly 8%, respectively) plus above average (>4%) position sizes. (Note: the calculation for contribution to return considers a position's size as well as its share price gain or loss, recognizing that the larger the position the greater its impact on total portfolio performance, and vice versa.)

Two other standouts from the first quarter are also on a top five list this second quarter – the list of largest detractors. **Cytori Therapeutics (CYTX)** and **Universal Display (PANL)**, both notable performers for the three months ending March 31, 2011 gave back some of those gains as their share prices dropped 39% and 36% respectively. The portfolio's returns were further muted by **Cree (CREE)**, down 27%; **Google (GOOG)**, down 13%; and **Masimo (MASI),** down 10%.

Our clients might wonder about the not uncommon phenomena of a Growth Equity stock holding being mentioned as a prominent winner one quarter, and then suffering a noticeable drop shortly thereafter. Such is a fact of life in growth investing. Growth stocks, particularly the smaller company growth stocks that typically comprise a portion of our Growth Equity portfolios, will often trade at prices much higher than average relative to their earnings and/or book value. Such extended valuations tend to make growth stocks more sensitive to short-term interest rate shifts, economic change, and relevant news, expressed through above average share price volatility. As discussed in the Portfolio

Activity section later in this review, in some cases we look to take advantage of shorter-term price moves, and in others we prefer to ride through the volatility. And volatility there was during the second quarter.

STOCK COMMENTARY

Seattle Genetics, mentioned briefly in our fourth quarter 2010 review as one of the few negative performers for that period, posted a nearly 32% gain in the most recent quarter and is now trading at about double the price paid when initially purchased for Growth Equity portfolios in mid-2009. Our attraction to Seattle Genetics relates to its bifurcated business model. Unlike many life science companies which must use cash to both research and develop a therapeutic, Seattle is unique in that the company has developed a set of technologies that it licenses to other firms as well as uses itself to generate drug candidates. The technology half of their business model mitigates the risk of failure of any one drug candidate. The stock has been trading up of late due to expectations surrounding the progress of one of its drug candidates, Adcetris, which treats Hodgkin's disease and large cell lymphoma. During the recent quarter Seattle released study results supporting Adcetris' claims of efficacy, durability, and also safety. These positive results increase the probability that sometime in the third quarter Seattle will receive FDA approval to market the product in the U.S. Seattle's stock price is, however, not without risk: there is some debate over the size of the market for Adcetris. Such debates will become increasingly prevalent as pharmaceutical companies focus their efforts on biologics that treat specific disease states (with narrower market potential) versus the drugs of yesteryear which treated broad scale problems such as vascular disease that affects a greater proportion of the general population.

The top contributor for the quarter, **Mako Surgical**, has had a very strong run year-to-date, up over 80%. Mako has many similarities to Intuitive Surgical (ISRG), the medical device company that might have spoiled a generation of healthcare investors with its very attractive business model. Intuitive, the maker of the DaVinci robotic surgical device, is a standard razor-and-razor-blade business model: a hospital not only buys the device, but also repeatedly purchases single-use replacement tips from Intuitive, thus providing Intuitive with a less volatile and highly profitable 'consumables' business. Every investor—and venture capitalist—has been looking for the next Intuitive, and a few of us believe that Mako is such a company. Mako is attempting to do for knee surgery what Intuitive has done for urologic procedures. Mako is the only company currently manufacturing and selling a robotic device for orthopedic surgery. The company received an order for seven of its RIO systems during the second quarter, which was the catalyst to the stock's recent price surge.

Cree, which had a spectacular run from a low of around $15 in 2009 to nearly $80 per share in mid-2010, has dropped off about 50% since the beginning of 2011. We took some profits off the table in early 2010 in those Growth Equity accounts that held the stock through that run. Considering its recent price drop, we are now considering rebuilding those positions. Cree holds an estimable place in LED lighting, a technology that uses semiconductors to produce light. As advances in semiconductor manufacturing have lowered the costs of producing LED's, their potential as light sources has increased dramatically. Our original investment thesis for Cree was to enjoy the growth of LED lighting for general use, first in the form of government sponsored replacement of street and other municipal lighting, then commercial replacement such as indoor office lighting, and finally home lighting. Yes, our expectation was that the traditional incandescent light bulb would disappear over the next several years. That may take a bit longer than originally expected, but in the meantime, a positive surprise occurred: LCD TV manufacturers are using LEDs in TVs as a source of backlighting. This application took off in 2009 when LED-based TV's became a selling point for manufacturers. Unfortunately, the demand for LCD TV's has leveled off and so has the immediate growth expectations for component makers of the TVs, including Cree. However, we still believe the switch-over to LEDs in general lighting is approaching, but it is taking longer for the parties in the supply chain to make the conversion from incandescent to LED. When this occurs, it should usher in a longer period of sustained growth for Cree.

We talked about **Cytori** in detail in our first quarter 2010 letter. Briefly, the company has developed a stem cell therapy for the reconstruction of breast tissue. The company currently has an application in front of the FDA for use of this therapy in the U.S. In March Cytori released positive fourth quarter 2010 results along with positive news stories about the progress of its research on this reconstruction therapy, and the stock finished that quarter on a tear. However, announcement of weaker first quarter results largely reversed those gains, and the stock's price is basically back to where it was at the beginning of the year. Our outlook for Cytori remains positive, believing the company will receive approval for its breast reconstruction therapy in the not-too-distant future. We also see opportunity in the company's technology applied to other avenues. A recent study released by Cytori described the benefits of its cardiac cell therapy to heart attack victims.

PORTFOLIO ACTIVITY

Portfolio restructuring during the second quarter was minimal. In late April we established a new position in **Hansen Medical (HNSN)**. Like Intuitive and MAKO, Hansen is in the business of making robotic surgery instruments. Hansen's specialty is flexible robotic instruments that can be used to accurately position and manipulate catheters. We are anticipating FDA approval of Hansen's device sometime late in 2011 or early 2012. Once approved, we believe vascular specialists will not take long to recognize the unique qualities of Hansen's approach, and sales growth will follow. Hansen recently received an investment from Philips which reduced its enterprise risk while also providing some support for the technology.

Towards the end of May we eliminated our entire position in **Adobe (ADBE)**. The stock was introduced to Growth Equity portfolios in early 2009 when the equity markets were becoming unglued. We saw that period as a chance to acquire the shares of a very high quality software franchise growing at a reasonably attractive rate for a very good price. Since then, the stock price has appreciated quite a bit, and our opinion of the company's future growth prospects is waning. Specifically, the two primary sources of Adobe's historical growth, the creation of a suite of products and the acquisition of major PC software to combine with that suite, are near the end of their run. In the future, the company's rate of growth will increasingly depend on the secular growth of its end-user markets. Although we think the end-user markets can continue to grow at an above-average rate, we don't think it justifies paying a large premium. Additionally, Adobe faces risks in moving its products to the popular subscription, cloud-based distribution model. (You will undoubtedly hear more from us about 'cloud computing' in future quarterly reviews, as we believe cloud computing is a real trend that will affect many corners of the software and service market.)

Concurrent with the sale of Adobe was our purchase of shares of the German company **Bayer AG (BAYRY)**. (We purchased the shares in ADR form. ADR stands for American Depository Receipt and is the mechanism through which the stock of many non-US companies is traded on U.S. financial exchanges.) Bayer has attractive pharmaceutical and agriculture chemical operations which should both provide above average growth, and has, by our measures, appealing valuation. Our return expectations for this Bayer holding are not as high as our expectations for some of our smaller company holdings, but we believe Bayer provides a higher probability of realizing its return potential, as moderate as it is. As noted in prior quarterly reviews, we continue to see attractive valuations in some of the larger firms we research versus the smaller companies in our universe, even considering the slower expected growth rates of the larger firms. Bayer is an example of one of these larger, world-spanning companies profitably exposed to growth markets but priced attractively.

MARKET COMMENTARY

We are not professional economists, but like other portfolio managers we must acknowledge the environment we invest in and consider how larger economic factors might affect our holdings individually or collectively. Hence the following comments.

Greece and Europe: In response to the excess debt challenging Greece and several other European countries, certain European creditor countries are forcing an extended curtailment of consumption on the debtor countries. We do not believe this approach provides the debt-burdened economies with the relief required to overcome their over-indebtedness. In fact, whether the indebted is an individual, a corporation, or a government, there is really only one way to solve the problem for all involved: the lender must reduce the principal amount of the debtor to a point where the indebted will be able to pay its obligations. It's clear to us that the arrangements put into place to manage the Latin American debt problems in the 1980's should be utilized again, in Europe. In short, holders of European sovereign debt will need to take a cut in the principal owed to them, to the point that the indebted country can operate on a somewhat normal basis, as opposed to implementing activity smothering 'austerity' measures such as those most recently proposed for Greece. Some European officials worry that reducing the principal Greece owes will lead to further principal reductions on other countries' debt; it is this 'run on countries' scenario that finance ministers fear most. Some government intervention will be necessary to alleviate such fears, but we believe government action is better used to reduce the principal owed than by smothering economies and slowing tax receipts.

How will this affect the markets? In the near-term, ham-handed approaches by governments will cause volatility in the markets, and by that we of course mean downside volatility. The longer-term effects on the markets depend on the remedy. If governments agree to principal reductions but execute such with soothing emoluments, we believe there can be growth again. If governments continue down the path of enforcing unrealistic levels of debt, then we believe we will see an extended period of subpar growth. If the European monetary authorities decide to loosen monetary control, it would likely mean inflation although it would alleviate the immediate debt challenge. Which path will the European governments take? We can only watch and react. Our hope is that the governments will courageously face the challenge, but our expectation is that they will pursue the path of least resistance until the indebted countries' pain level reaches a breaking point.

U.S. Housing Market: The continued troubles in U.S. housing are a secular worry, but they would benefit from the same medicine prescribed above: mortgage principal reductions would clear the balance sheet problems of a large swath of U.S. consumers. Remedies proffered by mortgage-holders in the past few years primarily involve temporary interest rate reductions. This has done little for homeowners as it turns them into renters given that there is no or negative equity building in the homes in which they live. Experience has shown that mortgage principal reductions lead to better outcomes for both parties laying claim to the house, the mortgage holder and the owner. Principal reductions imply pain to the mortgage holders, but also imply pain to those companies that guaranteed the mortgages, including the government agencies Fannie Mae and Freddie Mac. If some sort of principal reduction program is not put in place, we expect to see sub-par growth for the U.S. consumer and therefore limited demand for those companies strictly serving the U.S. consumer.

In sum, the excess levels of debt that have built up since the mid-2000's will continue to limit economic appreciation in the developed markets until they are cleared. Remedies that do not involve a reduction in principal are likely to further extend the current slow-to-no-growth economic environment as debtors take years to pay off their obligations.

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