YOUNG ENTERPRISE SHARES (YES)
PORTFOLIO REVIEW

Fourth Quarter 2011

PERFORMANCE COMMENTARY

What's not to like about a quarter that returns 11.8% for the S&P 500, or even better a 13.3 % return in the Russell Micro Cap Growth? What's not to like about the domestic US equity markets that outperformed virtually all other world equity markets? For such outstanding returns it sure didn't feel like a great quarter, based on both commentator and investor attitudinal responses.

This sour mood is due in part to the parade of headlines about a looming European recession and slowing global economy, the continuation of wrangling and political posturing in Washington, the lack of visible leadership of the President, and the evidential likelihood of little plausible potential leadership as depicted by the Republican primary debates. The returns of the quarter came only from a sharp short spurt off the early October bottom. November ended on a sell-off and the Santa Claus rally of December never came to fruition. December made up just enough to recover from November - taken together the two months were essentially flat).

To those old enough to remember the old Alka Seltzer jingle, it was simply a "plop plop fizz fizz, oh what a relief it is" quarter. However, the hangover remains. A caustic attitude still prevails in both the hearts and minds of most investors. Ghosts from 2008 are still haunting investors' psyches, as deep scars remain, and the hurdles ahead appear to be intractable as we seem to be lacking in corporate and political leadership both here at home and in Europe.

For YES, this quarter was not a relief but a significant disappointment. Performance lagged in the bounce of October and was down against the broader market's November and December flat performance. It is understandable that large-cap dividend-paying stocks had a good quarter with all the uncertainty in the headlines and market volatility. To a degree, it is a head scratcher as to why our companies performed so poorly in the quarter because there was little fundamental disappointment. There was a bit of a slowdown in short-term growth in headlines and to a lesser degree in reality. But investing successfully in this space has always been about indentifying companies that have the combination of product and management that can build value over the long term. Trading in and out of these companies is in some ways akin to day trading. To quote Kenny Rodgers from the song "The Gambler", "You got to know when to hold'em, know when to fold'em" (which incidentally was written by a college friend). Young company stocks move in runs and missing a run is easy to do if you are not there. There can be significant risks missing an upward move (or savings missing a down move). We are not gamblers but do take calculated bets investing in these names. Our bet is that the companies we own have the potential to build truly significant value. We generally prefer to "hold'em" in the belief that we have a winning hand that will amass a pile of chips at the end of the game. We took our lumps this quarter but have every expectation of being able to report a better first quarter in 2012 and forward unless there are significant macro issues, since the micro issues relating to these stocks are on the whole very favorable.

The companies that made a positive contribution to the quarter were **Vical (VICL)**, bouncing back from leading on the downside last quarter, up 78%, **FEI Corp (FEIC)** up 42 %, **Solazyme (SLZM)** up 29%, **Nektar Therapeutics (NKTR)** up 17%, and **Finisar (FNSR)** up 36%. Looking at those percentage returns one wonders how the quarter was so poor. These stocks bounced off the Q3 bottom and the rest of the portfolio lagged or continued to sell off. The five companies that most significantly hurt performance were **Universal Display (PANL),** again after leading on the upside in Q3, minus 22%, **Hansen Medical (HNSN)** minus 22%, **AXT (AXTI)** minus 17%, **Microvision (MVIS)** minus 56%, and **Cytori Therapeutics (CYTX)** minus 34%.

PORTFOLIO COMMENTARY

We added **Entegris (ENTG)** to the portfolio in October. We often find one or more specific companies to invest in following an attractive trend; however, we are always on the lookout for relatively lower risk ways to do so. There is little doubt that the overall demand for semiconductors will continue to grow with the proliferation of mobile devices, demand for cloud computing, increased utilization of the internet, etc. In the case of ENTG, we are investing in a company that provides needed products to the manufacturers of semiconductors. Entegris' products and materials are used to process and manufacture semiconductor chips. Products range from liquid and gas filtration products critical to the manufacturing process, to wafer handling and shipping products, and data storage products, which preserve the integrity of wafers and electronic components at various stages of transport, processing, and storage. They also provide specialty coating products for chemical vapor deposition coatings.

We also added **Vertex Pharmaceuticals (VRTX)** to the portfolio in December. VRTX discovers and develops drugs for the treatment of critical diseases. The company's hepatitis C drug is the market leader after just a few months of marketing by a new sales force, and has outpaced Merck. Vertex's first-in-the-world treatment for cystic fibrosis now awaits FDA approval. Their second CF treatment, to address a broader segment of the sufferer population, is in development. Their drugs to treat epilepsy and rheumatoid arthritis are in clinical trials. With this achievement of commercial as well as scientific success, we thought it timely to add Vertex to the portfolio.

Portfolio activity in the quarter can best be defined by tax loss selling and tactical decisions to swap positions in similar companies. December was an active month. As a rule of thumb, we are generally not inclined to sell what we believe are companies with solid fundamentals and promising futures for tax losses. When investing in small creatively driven companies, the timing of value recognition can be extremely difficult to gauge from either a micro perspective (due to slower than anticipated adoption rates of markets for products or products to develop) or from a macro perspective (negative investor sentiment). All too often these companies recover and attain our price objectives over time **-** it becomes a matter of delayed recognition of value. This year, because the prices of some of our companies were so depressed, we did take losses. We sold long time holdings in **Aixtron (AIXG), Cree (CREE), Cytori (CYTX)** and **Isis Pharmaceuticals (ISIS).** We will likely revisit CREE, CYTX and ISIS again as the future for lighting and displays, stem cells, and therapeutics is so promising.

We also sold relatively recent purchases in **NuVasive (NUVA), JDS Uniphase (JDSU)**, and **STEC (STEC)**. We sold NUVA (a medical device company addressing spinal fusion surgery) because they lost a patent suit to Medtronic in the Fall and the appeal process is likely to drag on in the court system leaving a cloud over the stock. The market for device companies for spinal surgery continues to be very competitive as well. We sold JDSU and STEC more as swaps for tax loss selling. We added **Finisar (FNSR)** as a swap for our JDSU position. Both address similar markets, have competitive products, and quality managements. Swapping JDSU for FNSR enabled us to take a loss yet maintain exposure to a segment of the market we believe to be oversold.

The same concept holds true for our sale of CYTX and ISIS. We used the proceeds to add to our existing position in Nektar Therapeutics and to establish a new position in Vertex (VRTX). This position maintains our exposure to companies developing drugs to address disease states closer to commercial development stage.

We applied the losses to gains taken by reducing our positions in FEI Company (FEIC) and Universal Display (PANL).

MARKET COMMENTARY

Looking rearward (instead of forward) is rarely a very important guide for long-term equity investment, especially so for young rapidly growing enterprises. Circumstances now, however, suggest that returning to a view of 2011 might be especially useful. The past year was an unusual year in many respects that adversely affected prices of shares, and very unduly so. Accordingly, 2012 is quite likely to be a make-up year and much more, as the American economy moves forward, notwithstanding the acrid winds of politically inspired rhetoric.

First, take a look at charts of share price indexes. The forepart of the year brought a general, moderate elevation of prices, which gave way to the apprehensions (misapprehensions) and sour-mouth commentaries that foment widespread fears. Share prices plunged from July's plateau to October, then rallied, and plunged again in November, aggravated by tax loss selling, and in part to wariness broadly among investors owing to the volatility, itself. In hindsight, it becomes increasingly clear that neither of the two downthrusts should have happened. Viewpoints and anxieties, spurious as they were, became the reality momentarily.

For the most part, it was only the high dividend yielding shares (utilities, pharmaceuticals, and large telecommunication providers) that escaped the downward force of fear and despair. Shares of young companies (that rarely lead in downturns or upturns) were eventually trashed, owing to their having not yet obtained wide market recognition and ownership. Such shares move excessively downward under extended general market stress, and race upward in make-up spurts after recovery rallies show strengthened legs for extended gains. Such is to be expected.

For the shares in our Young Enterprise Securities universe, none disappointed in their internal progress. Thus, all were inherently of greater worth at years' end than at the years' beginning, but their market values were substantially reduced for most; and for some cut in half, or more. Illustratively, if all in our universe returned to their highs of the forepart of 2011, more than a doubling of market value would result. Given the continuing internal progress of the enterprises, it is not too much to expect greater gains before 2012 becomes history.

The January flow of quarterly corporate reporting continues to affirm spreading economic growth in America, and greater growth throughout most of the world, with Europe in a still-to-be-solved stall. Europe is too often cited as a reason to harbor funds. At its center, Germany, Europe is strong. There is societal weakness in certain small peripheral nations. There is strength also in its large multinational enterprises (as are those in the USA) whose revenues are derived in large measure beyond the boundaries of their resident nation. A focus on commerce will serve investors better than attention to politics — never unimportant, but rarely primary.

Let's have another look at 2011 to perceive how well the shocks of natural misfortunes were absorbed. A year ago a tsunami of the centuries slammed Japan, with worldwide dislocations in supply-chain flows and implications that encouraged expressions of anti-nuclear energy sourcing. The weather pattern for America was off-the-charts across the land: (1) excessive spring flooding in the upper Mississippi basin and late plantings, (2) tornadoes from Alabama to Massachusetts ravaged beyond any such damage recorded, (3) a summer hurricane in the eastern United States setting new high record for damages, (4) droughts from Georgia to Arizona with extensive wild fires, (5) an unseasonably mild winter thus far in the central and eastern portions of the USA, and (6) late year terrible flooding in southern Asia. Imagine the dislocations in retailing, transportation, agriculture, and supply chain disruption of components, especially for the electronics industry. To have countered such misfortunes is testimony to strength and adaptability. The dour descriptions of our times seem to give little recognition to such. These have shown some depressing effects upon earnings as scattered throughout commercial and industrial companies, which, nevertheless, show strong and (probably persistent) overall gains. Our specific concerns relate to the automobile industry, which has performed so remarkably well. Some throttling back in this big industry would not be surprising in nearby months.

Greece hovered as a small dark cloud that ever occluded the sun, and shuttered vision of the activities of financial entities that continue as the principal source of perils. This, too, will pass eventually.

A slow growth American economy, a slower growth world, are both supportive to long-term equity investment. Interest rates will remain low, speculative excesses will not be encouraged. More rational deployments of liquidity (abundant) will ensue. For investments, choose vessels with strong propulsion systems. We ever remind our clients that it is not our Firm but the managements of well-focused, well-conducted companies that provide the good results. Young companies, categorically, go in and out of seasons in the fashion-prone financial industry. There is an unfolding prospective season of extraordinary good results, partially clouded still by political rhetoric and gamesmanship, and by widespread wariness born of the hyper volatility of the markets.

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