YOUNG ENTERPRISE SHARES (YES) REVIEW

Second Quarter 2012

A COMMENTARY REGARDING MARKET MISPRICING PRACTICES

This letter is framed in three sections: First, to reference the share price sinking spell experienced in the quarter just ended, to be followed by a second section that focuses upon characteristic aspects of the market that contribute to the buffeting of prices into unnerving volatility, and a third section that broadly scans more enduring circumstances that affect prices of marketable shares. The purpose is to perceive daily and monthly volatility as couched in broader market phenomena and attributes. The complexity of the marketplace has grown exponentially year-by-year, apparently outpacing the comprehension of citizens, and of officials of governments with responsibilities for supervision.

For investors in equities, the second quarter of this year was nasty, virtually eliminating most (and for some, all) of the gains of the first quarter. For investors in small companies, and for our clients who choose our *Young Enterprise Shares* (*YES*) strategy, share-price erosion in May was traumatic. Oddly, this was contrary to enterprise affairs and progress, which proceeded well for the companies chosen, with very minor exceptions. In the context of present circumstances, it is more germane to comment upon market characteristics than upon corporate affairs.

In the comprehensive universe of the companies that we follow from which selections are made for the *Young Enterprise Shares* strategy, twenty-three companies experienced a fall in the price of their shares during the quarter, and thirteen experienced an increase. Of those thirty-six enterprises, none experienced a significantly inimical event — such as the loss of key personnel, or loss of a major customer, or a contractive change in the market for product. For company shares in the portfolio of a small internal fund that is representative of the *YES* strategy, eighteen share prices sank, four advanced — all four were biotechs.

Vertex shares advanced very sharply in response to approval by an FDA administrative panel of telaprevir (a therapeutic agent for hepatitis C) that predated (and extended into) the quarter. Universal Display received very good news from Korean producers of electronic displays that presages a bountiful second half (and thereafter) that is now clearly underway. Several companies are working out well from preceding minor, temporary shortfalls. It is surprising to see the degrees of price retreats when only a very few mildly disappointing and passing difficulties were made evident, and the prospective future is undiminished. Immediately after the quarter, shares of Mako were unduly slammed in response to slightly less than expected equipment deliveries and surgical procedures. Evidently, progress very generally was good in terms of incremental inherent worth of the enterprises. So, progress gets recognition in the quarter in reverse expression of increments of worth. This is the paradox in explaining the market and in explaining, especially, this small-company "sector" of the market.

For our *Young Enterprise Shares*, categorization breaks down. For investors, this has little basic relevance; for market traders, it is a convenience. The commonalities between these young companies are so slight, the specificity of each enterprise is so peculiar to its own product line, there is too little similarity to support cross responsiveness. In fact, managements of most of these companies do not know most of the others exist. Given today's market practices and methodologies, these companies are frequently treated as bundles of the same. Though their products address totally different applications, these still get painted with the same brush. Thus, intelligent investors need to pay attention, enterprise by enterprise. So long as these are progressing well, and creating wealth inherently for their respective enterprises, steady progression in reported earnings should not be seen as a requirement. It is the inherent progress that counts. Their value will be recognized sooner or later because their conspicuous extraordinary growth rate eventually makes such happen.

Valuations have never been so cheap except at the pit's bottom in 2008. These companies have never been more vigorous. The variety has never been so exciting from the standpoint of social significance. And, in totality, the creativeness of those (still young, not yet a generation old) engaged in the life sciences matches that of the great majors. In most of the world, research and development is mainly conducted in a very few major enterprises, or in national agencies. For America, the entrepreneurial inventiveness and venture capital sponsorship of new creative entities, in totality, hugely benefits social wellbeing. For investors, patience has commonly been pleasingly rewarding.

II. A Very Short Course Re Price Rattling Market Practices

Outsized impulsive fund managers can throw billions at any moment. Categorical trading glosses over in disrespect the characterizations by enterprise analysis. Categories, or classifications, are first by size, and some by selected industries. Designation is also made according to Alphas, Betas, R-squared, and other volatility quotients. Large scale is facilitated by the buying and selling of indexes or ETFs. Some identifications are as superficial as the price of the shares, accordingly as approximately $10, or $5, or $1 per share. Some large institutions will not invest in shares below $10, and brokers commonly do not accept shares below $5 as collateral in margin accounts. Occasionally, hundreds of similarly-priced shares will fall or rise in the same magnitudes in unison, because large traders require bundles for worthwhile scale. Combined with "risk-on-risk-off" instructional mandates used by trading funds, the disregarded merits of companies get overwhelmed in daily activity. Also, inasmuch as the scale of market capitalizations of small companies does not allow large traders to deploy their funds in sufficient scale, they use tradable indexes, or their own clustering, for positioning (irrespective of analysis of a company's affairs, products, or progress). Illustratively, the extended price weakness recently in Biolase shares was attributed by the Company to a compiler of indexes having removed the Biolase shares from its index, and the shares had to be sold accordingly by such index owners.

Months ago, the *New York Times*, reporting upon the increased use of computer-driven trading (estimates for which have placed more than three-fourths of daily trading), noted that in northern New Jersey alone, in new buildings near the Hudson River, there is 163 million square feet of floor space dedicated to computers for high-speed, large-volume trading. In acres, that is 3,742, an equivalent of one noteworthy plantation. And, when scaled to include locations elsewhere in the United States and in other financial centers, it is mind boggling.

The growing emphasis on trading in large quantities for small immediate gain (long or short) has led many sell-side analysts to narrow the focus of their reports to magnify "minutiae for the moment". It brings to mind the often-heard remark: show me a large short and I'll show you negative analytical reports in support thereof.

Megatrends Downward Prepare Base for Megatrends Upward

In much broader sweeps, take a look at more general evidence of this phenomena: revenues up, profits up, and stock prices unresponsively flat or down. That applies to companies throughout the full range of size and quality. Explaining its origins might have some help in gauging the duration of this phenomenon, though there are no reliable clues as to when the shadowing clouds of doubt will disappear.

These megatrends (since the turn of the century) were formed by the hot-stock bubble burst in 2000, and followed by a financial industry so overgrown and carelessly entrepreneurial that it collapsed from its own excesses, imposing on economic activity in turn. In simplest terms, the secular downtrend in market valuation of the worth of equities is expressed in price earnings ratios. Reductions were general; and for many, the cut reduced to 1/2 or to 1/3 of former capitalizations of earnings. This mega downtrend in valuations is additionally extraordinary for its having happened against the backdrop of falling interest rates. Usually (normally), rising interest rates erode the price/earnings valuations. Surely, this experience of the last decade appears to be the longest ever in which valuations eroded contrawise to the opposite, elevating effects of declining interest rates. This countertrend is the likes of which no living person has seen before.

You may check this out quickly for yourself by making a list from the best growth companies — such as IBM, Microsoft, Intel, Cisco, Corning Glass, Oracle, Adobe, Boeing, GE, Coca Cola, Pepsico, Johnson & Johnson, and many more. You'll find their revenues and their earnings are up by several multiples, and their capitalization reduced by two-thirds on average. Their buildup of cash balances is above extraordinary. Among a list of this sort, only a few (Apple and IBM being outstanding) have stock prices significantly higher than a decade or more ago. If one owned only these mentioned, the net capital appreciation for the twelve years would have been only the equivalent worth of a large bag of peanuts. If a list is made for small companies, the results are more dramatic. However, the representative character of the universe becomes more difficult because smaller companies so often combine in one way or another. Furthermore, there is such a dissimilarity of enterprise characteristics among the smaller companies the validity of the universe is attenuated.

Often, we hear investors say: "it is scary out there". Before recovering from the effects of Bernie Madoff and Robert Sanford, there was the MF Global blow-up and denouncement of Russell Wasendorf of Peregrine, all defrauding their clients. The largest of U.K. banks (along with a handful of other leading banks) dominate the headlines owing to revelation of years-old deliberate unlawful deception pertaining to LIBOR (London Interbank Offered Rate). And, from America's top bank, a goof of enormous scale in a practice traditionalists would say is totally inappropriate for a bank — no matter that these banks also used government assistance to survive their own concerted follies less than four years ago.

Well, the spin on this bad banking news, horrid as it is, should be spun into good news. It could be better only if the scale were more frighteningly larger. Even as it is, regulators are called into question, and parliaments and national legislative bodies are being energized.

Banking is a service industry from its raison d'être. Banking does not create much wealth in its own right, but financially enables others to do so. Fundamentally and essentially, banks comprise a nation's currency — as the "coin and franca" of the realm —on which all persons could trustfully rely. Do we need more evidence to know that "something is rotten in the State of Denmark", and fixing it is of paramount importance? Will banking ever get back to trust and service? Yes, partially so. This is underway now, as the "good news" aspect. Deleveraging everywhere (enterprise and household) is good news, for it is essential to establish soundness (though it might seem as water torture while proceeding).

As for general circumstances, these are quite propitious for perceptive equity investing. The news has a dynamic in it from the no-matter, shop-worn news of Greece to the open-ended news from the "Arab Spring", and the aspiring populaces in developing nations. The dynamic is suffused with hope, while the spin is laced with fear and doubt. The economic news is supportive in revealing a moderation of yesterday's excesses; the spin is sour. Enterprise news is positive for the massively strong companies and for the creatively driven enterprises, and the spin is wrapped in negative "yes-but" tissue.

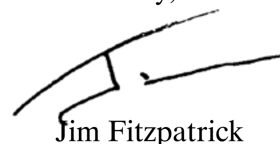
No one can predict when better sentiment will support more realistic valuations of equities; yet, one aspect is sure: The unrelenting abnormal cheapening of equities create (coincident with a lowering of interest rates and withdrawal and sequestering of investible funds) the foundation for one of the longest uptrends ever, as consistent earnings are valued more highly (expanding P/E ratios). Today's low P/E ratios for fine enterprises growing upwards of 5% per annum meet no test of reason when interest rates are a small fraction of commercial growth.

The huge scale of withdrawn funds cannot re-enter common shares without elevating prices very generally and greatly (as a mere physical matter). It is comparable in Europe. Major insurance companies and pension funds formerly held equities in percentages of assets ranging from the mid-teens to the mid-twenties. Now, it ranges from zero to five percent, commonly. How will they ever get such volume again into equities? When the hang-up breaks, all marketable objects will be propelled by the wind. The downside, as always, is one magnitude, the general advance would easily exceed one magnitude for many, and several magnitudes for shares of young enterprises.

III. Periodic Commentary

Enclosed is a periodic commentary sent two weeks ago to clients and friends as a contemporary perspective that keeps them up to date with our viewpoints. It is in support of the interpretations given herein.

Sincerely,



Jim Fitzpatrick

Enclosure