

2010 First Quarter Market Review

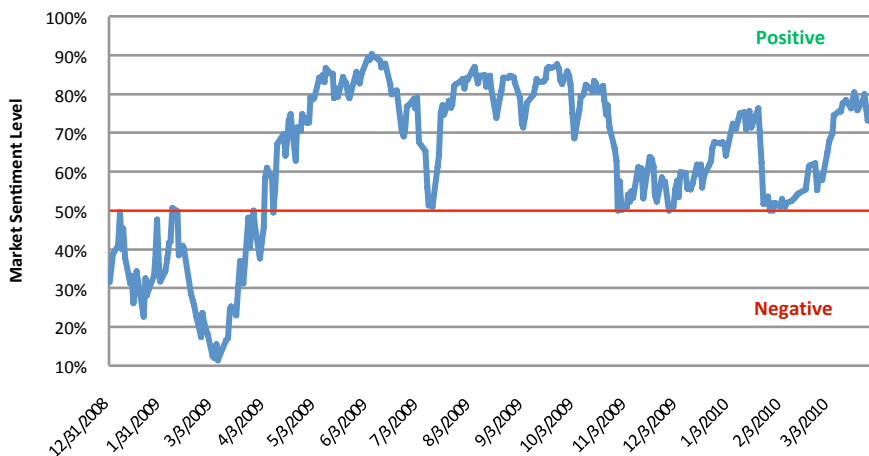
Do You Like Roller Coasters or Waterslides?

Now that spring has arrived, kids are excited about visiting their local amusement parks to ride their favorite roller coasters. With the recent gains in the stock market, investors also seem to be queuing up again for the roller coaster ride in stocks. US markets continued their climb in the first quarter of 2010 with the S&P 500 Index gaining 5.39% on the quarter, the Dow Jones Industrial Average gaining 4.81%, and the Russell 2000 small cap index gaining an impressive 8.85%.

Although foreign stocks outpaced domestic stocks in 2009, they did not have a repeat performance in the first quarter. Foreign stock gained only 0.98% for the quarter due to the rebound in the U.S. dollar and concerns over sovereign debt issues in Greece which affected markets across the entire European Union. Emerging markets did not fare much better as the MSCI Emerging Markets Index gained only 1.50% in the quarter after having generated sizable returns in 2009.

Baker Avenue's Market Sentiment Indicator (BAMSI) began the year in positive territory, but dipped into neutral territory during the -9% correction between the second half of January and early February sparked by concerns over Greek sovereign debt default. Market sentiment returned to positive territory again in middle of February as the market discounted the Greek debt contagion fears and there was further evidence of an economic recovery in the U.S.

Baker Avenue Market Sentiment Indicator



The Importance of Risk Management

While the recent market climb has been encouraging, the side-effect of rising markets is that investors tend to forget the importance of risk management in investing. Investing legend Warren Buffett may have said it best when he quipped, **"The first rule of investing is don't lose money; the second rule is don't forget Rule No. 1."**

While the S&P 500 benchmark has had impressive gains since the March 2009 lows, investors have had to endure substantial risk to enjoy those returns. Many investors may be familiar with the common buy-and-hold mantra on Wall Street that, "If you

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miss the best X days in the market, you will miss out on Y amount of returns." What is often conveniently omitted is that in order to experience the best days in the market, investors also have to suffer through the *worst days* in the market first! Very few investors have the financial resilience or the emotional fortitude to suffer through big declines in their portfolio before seeing their portfolios rebound. Needless to say, investors endured many sleepless nights in 2008 and early 2009 before deciding finally to cash out.

It is no surprise therefore that the average investor tends to ride the stock market roller coaster to the top of the market, but exits the ride at market lows. Take for example the lows made in March 2009. Data provided by the *Investment Company Institute* shows that investors in equity mutual funds sold nearly \$26 billion worth of equities at the bottom of the market cycle in March. Conversely, nearly \$19 billion were purchased in equities at the market peak in 2007.¹

Without the technical tools to gauge market risk and important inflection points in the market, investors and Wall Street firms are at risk of repeating destructive mistakes of emotional buying at the tops driven by greed and emotional selling at the lows driven by fear in their investment portfolios. At Baker Avenue, we have the time-tested tools to measure market risk and to identify the important turning points in the market to determine whether to be invested or to move to cash to preserve principal.

Absolute versus Risk-Adjusted Returns

Now that the market has shown signs of stabilization, market participants are evaluating which investments to pursue that best meet their investment objectives. To accurately assess the performance of a strategy, investors should evaluate not only absolute capital returns, but also assess the amount of risk the strategy took to achieve those returns. In other words, investors should evaluate the *risk-adjusted* returns of their investment portfolios and not simply rank returns from highest to lowest in terms of their attractiveness.

For example, given two investment portfolios of similar returns, the investment portfolio that achieved the return with less risk performed better on a risk-adjusted basis than the portfolio which took on more risk. In other words, if you knew that Investment "A" had downside risk of losing 15% or gaining 20%, versus Investment "B" had downside risk of losing 30% or gaining 40%, most risk avoiding investors would choose Investment "A" over "B" due to its lower volatility.

Over the past five years, we believe Baker Avenue to have produced superior risk-adjusted returns versus the S&P 500. In positive markets, the All Cap Core strategy captured 104% of the upside versus the S&P 500 benchmark, but experienced only 34% of the decline in negative markets. Furthermore, the All Cap Core strategy experienced significantly less drawdown (the peak-to-trough decline during a specific period) versus the S&P 500 (see figure 2, page 3). Despite going through one of the worst bear markets since the Great Depression, the All Cap Core strategy experienced a drawdown of less than half the drawdown of the S&P 500 since the peak of the market in 2007. Most Wall Street firms suffered drawdowns far worse than that of the S&P 500, like the venerable Legg Mason Value Trust Fund and the Dodge & Cox Stock Fund which suffered drawdowns of 66% and 58% respectively (see figure 3, page 3).

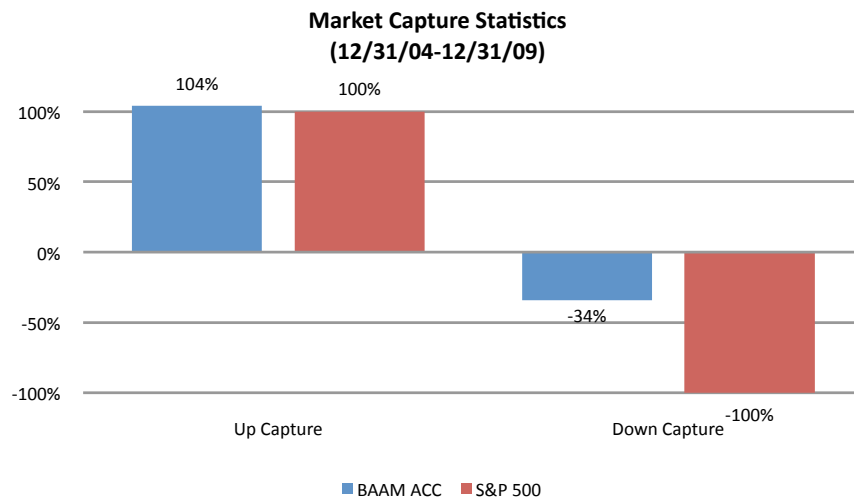
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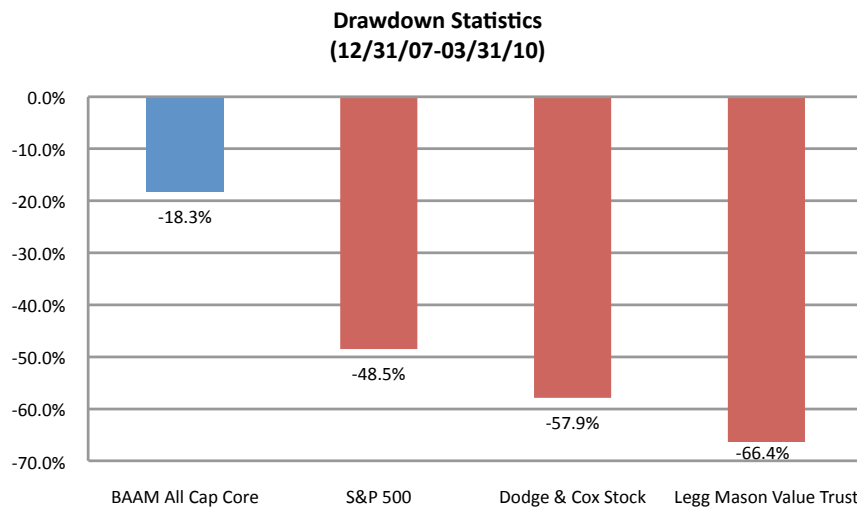
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Figure 2



Source: Informa PSN

Figure 3



Source: Bloomberg

Although we have rallied significantly from the lows of March 2009, drawdowns like the ones investors endured through recently *can* and *will likely* happen again in our lifetimes. Will investors be prepared for the next big dip in the stock market roller coaster? Without proper tools like Baker Avenue's Market Sentiment Indicator and objective investment guidance, we believe investors are likely to suffer through another repeat of Wall Street history.

Relative Strength Investing

When our Market Sentiment indicator is positive, we employ relative strength (momentum) strategies to invest portfolios. Relative strength strategies invest in securities that are showing outperformance versus the market over a specified time period. This method of investing is based on the premise that stocks that are in positive trends tend to remain in their trends. Therefore, stocks that are in uptrends (high relative strength) tend to continue their moves higher.

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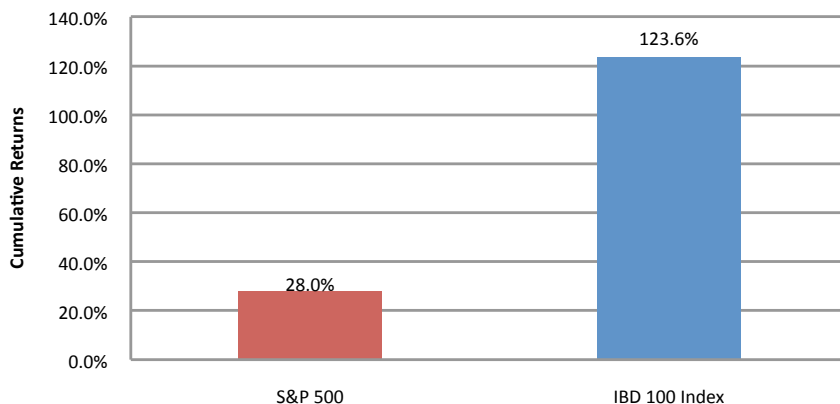
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The long-term performance of relative strength investing has been very lucrative as proven by numerous academic and professional studies. Although relative strength has been shown to produce very competitive long-term returns, there may be periods when short-term returns may deviate from long-term track records. Even with the variation of short-term returns however, portfolios composed of high relative strength stocks have shown a persistent tendency to outperform their weaker counterparts over time.

The chart below shows the performance of high relative strength stocks using the Investor's Business Daily IBD 100 Index[®] as a proxy. The Investor's Business Daily IBD 100 Index[®] is an equal-weighted index of the highest relative strength stocks in the market. What this chart shows is that although relative strength investing may have short-term performance that has variations with long-term performance, investors who are patient with relative strength investing are likely to see robust returns over the long-term.

Figure 4

High Relative Strength Stocks vs. S&P 500
5/5/2003 - 03/31/2010



Source: Investor's Business Daily

While we remain optimistic that high relative strength stocks will again lead the market, we are excited about the current prospects of the All Cap Core strategy. Our rigorous portfolio construction process combines technical and fundamental analysis to identify opportunities across all styles, capitalizations, and sectors.

Ford Motor Company (NYSE: F) is a good example of a stock that displayed high relative strength versus the market in 2009 which subsequently lead to high returns. We added Ford to the All Cap Core portfolio after our research indicated that Ford was to benefit from the shuttering of over 1,100 GM dealerships. Further, the "Cash-for-Clunkers" program was likely to provide a new stream of demand for their vehicles.

Express Scripts (NASDAQ: ESRX) is a leader in the pharmaceutical benefits management industry. The company recently reported sales that came in well ahead of expectations at \$8.2 billion, 49% higher than the reported figure during the same period a year ago. Express Scripts is now the second largest pharmacy benefits manager after the acquisition of NextRx. This transaction is likely to be a significant positive for the company and is likely to drive earnings growth going forward. The company's legacy business also continues to be strong as reported in its most recent earnings announcement. With the NextRX acquisition, the company will have access

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to a robust pipeline of new opportunities for 2011, including medium sized managed care organizations, state contracts, and employer groups. Express Scripts should also benefit from increased volumes in prescription drug demand due to the passage of the health care reform bill.

EZCORP Inc. (NASDAQ: EZPW) is a company in the pawn and pay-day loan business which in tough economic times tends to have attractive business opportunities. The company operates a network of 910 locations consisting of 369 U.S. pawnshops, 477 U.S. short-term loan stores, and recently started international expansion with 62 pawnshops in Mexico, and 2 short-term loan stores in Canada. EZCORP has shown consistent earnings growth in both recessionary and expansionary economic climates. In the most recent quarter, revenue jumped 44% to \$184.8 million. Earnings per share climbed 58% to 52 cents—24% higher than what analysts had expected.

We believe that the combination of in-depth fundamental research and strong technicals in stocks with high relative strength will drive returns that are competitive with the market over the long-term. This combined with the ability to move to cash in down markets provides investors with a unique recipe for long-term investment success.

Conclusion

With the market's sizable gains since March 2009, investors seem to be queuing up again for the stock market roller coaster. As in the past, the ride will be rough, jarring, and painful. Our strategy to protect principal in down markets keeps investors on a steady course—that is, we can benefit from the emotional extremes of fear and greed while maintaining a firm investment discipline. At Baker Avenue, we prefer waterslides over roller coasters—the ride is smoother and there is always a soft landing at the end of the ride.

Sincerely,

Baker Avenue Asset Management, LP

Our strategy to protect principal in down markets keeps investors on a steady course—that is, we can benefit from the emotional extremes of fear and greed while maintaining a firm investment discipline.

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BAAM All Cap Core Equity Composite consists of fully discretionary portfolios that invest in all cap equities and cash. The portfolios are designed to generate a positive return over the medium to long term, with a focus on capital preservation. For comparison purposes, the composite is measured primarily against the S&P 500 and the Russell 3000 is shown as additional information. The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, which represent over 80% of the investable U.S. equity market. The Russell 3000 index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. The minimum account size for this composite is \$100,000.

Baker Avenue Asset Management, LP ("BAAM") is an independent registered investment adviser. The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. BAAM claims compliance with the Global Investment Performance Standards (GIPS®).

The U.S. Dollar is the currency used to express performance. Returns are presented net of all fees and include the reinvestment of dividends, interest and other income. Returns are presented in US Dollar and presented net of an annual fee of 1.5% applied monthly which represents the highest annual fee currently paid by a portfolio in this composite. A minimum annual fee of \$9500, billed quarterly, in advance, is imposed per household. This fee is inclusive of management fees, brokerage commissions, portfolio monitoring, consulting services and in some cases custodial services. The composite consists of both bundled-fee and non-bundled fee portfolios. Since the completion of the first year, less than 2% of assets in the composite have been from non-fee paying accounts. The annual composite dispersion is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Additional information regarding policies for calculating and reporting returns is available upon request. Carve-outs are included in this composite from inception on January 1, 2005 until March 31, 2009. After March 31, 2009, only pure accounts were included in the composite. The portfolio accounting system automatically allocates 100% of the total cash to the carve-out.

The BAAM All Cap Core Equity Composite was created on January 1, 2005. Baker Avenue Asset Management, LP's compliance with the GIPS standards has been verified for the period January 1, 2005 through September 30, 2009 by Ashland Partners & Company LLP. In addition, a performance examination was conducted on the BAAM All Cap Core Equity Composite beginning January 1, 2005. A copy of the verification report is available upon request to info@bakerave.com.

¹
<http://www.ici.org/research>

All market and indices data are sourced from Bloomberg LP as of March 31, 2010 unless expressed otherwise.

The choice of Ford, Express Scripts and EZCorp were made on non-performance based criteria. This newsletter is provided to prospective Baker Avenue clients only on an unsolicited basis.