2010 Year-End Market Review and 2011 Outlook

baker ave

January 14, 2011

Regaining Upward Momentum

While we are optimistic about the prospects for 2011, in retrospect 2010 was perhaps one of the most challenging years we have experienced in recent memory. In the third quarter, the All Cap Core strategy notched its worst period of performance in its history relative to its benchmark. As investment managers we take the responsibility and stewardship of our clients' assets very seriously and often very personally, therefore 2010 was especially a difficult year. The unfortunate reality is that there is simply no single "silver bullet" strategy that will always outperform against every type of market environment. With that said, we are confident that our tactical strategy is the best option available for investors who want to get a fair return on their investment and outpace inflation, while also having the downside discipline to protect principal. We do not believe our Q3 underperformance is representative of what investors should expect from our firm's investment performance over the long-term. Looking back at the historical performance of our investment strategy, times when our strategy notably underperformed the market were followed by very good outperformance in the months and years that followed.

"We are happy to report that the measures we have taken have already started to pay dividends. The momentum we built up in the 4th quarter of 2010 has continued strongly into 2011."

In this letter we will address the reasons for our underperformance in Q3, discuss measures we have taken that will help prevent a repeat of Q3's performance, and outline reasons why we are optimistic for a strong equity market in 2011. We are happy to report that the measures we have taken have already started to pay dividends. The momentum we built up in the 4th quarter of 2010 has continued strongly into 2011. As we write this letter, we are outperforming the S&P 500 as well as the most widely held mutual funds on the market.

Reasons for Q3's Underperformance

There were several factors that contributed to the strategy's underperformance in Q3. The first factor is unprecedented market volatility amidst high economic and market uncertainty. After rising 5.4% in the first quarter, the S&P 500 Index tumbled 11.4% in the second quarter due to debt contagion fears in the Euro zone and continued fears of a potential double-dip recession in the US.

While market corrections are not unusual, *what is unusual* is the increased number of large price swings the market experienced in 2010. A high volatility market environment caused ten significant price swings in a range of between 8-21%, with an average magnitude of 12% *(Figure 1)*. It was a frustrating experience for bulls and bears as there was no clear market trend.

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Figure 1: Volatility of S&P 500 Returns in 2010

Source: Bloomberg

This heightened market volatility caused our Baker Avenue Market Sentiment Indicator (BAMSI) to give mixed bullish and bearish signals in August which led to a whipsaw effect. It marked the first time in over 24 years a bullish signal was triggered only to have it followed shortly thereafter by a bearish signal *(Figure 2)*. This led us to be fully invested and back into cash within weeks which resulted in having to realize losses in the portfolio. The market remained under heightened uncertainty early in the third quarter without a clear positive or negative direction.

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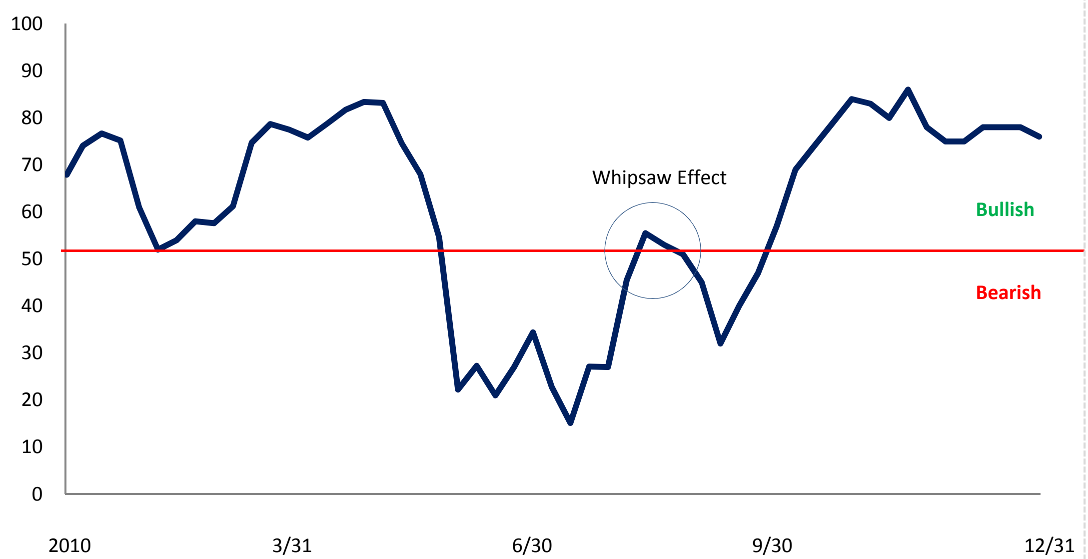
Figure 2: Baker Avenue Market Sentiment Indicator (BAMSI) 2010



Source: Bloomberg

Ironically, a contributing factor to our underperformance in Q3 2010 was our intention to minimize investment losses for clients in uncertain markets. *One of the most important tenets to our investment philosophy is the belief that minimizing losses for clients in severe down markets will lead to outperformance in the long-run*. Small losses are easier to recover than large losses. For example, investors who lose 10% in the market need only to generate 11% to breakeven, whereas investors that lose 30% in the market need to generate 43% to breakeven.

In Q3, faced with an over 9% loss for clients after the second quarter in which the market fell nearly 12%, we maintained high levels of cash and did not recommit assets in an oversold market due to mounting evidence that we were at risk of a double-dip recession amidst rising unemployment, anemic homes sales, looming risk of government debt defaults in Europe, and increasing market turmoil.

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With the benefit of hindsight, July was the bottom of the market as the economy managed to avert a double-dip recession. The Federal Reserve poured additional liquidity into the markets to buoy asset prices in the fourth quarter with another round of quantitative easing a la "QE2".

Investors should think of our objective to minimize severe portfolio losses akin to an insurance policy against severe market downturns. And like any insurance policy, a premium is paid for that protection. While in other years that premium is "free" due to good investment performance, that premium came at the cost of underperformance in 2010.

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Adjusting our Strategy for Current Market Conditions

While recent investment performance has been disappointing, we do not believe it is reflective of the true long-term potential of our strategy. Since inception, the All Cap Core strategy is outperforming the S&P 500 by over 20% on a cumulative basis with less downside risk despite going through the worst economic downturn since the Great Depression. Further, looking back at the historical performance of our investment strategy, times when our strategy notably underperformed the market were followed by very good outperformance in the months and years ahead. In light of the market's whipsaw action, we have made adjustments to our investment process that we believe will help avoid a repeat of recent performance should we see the unlikely event of 2010 style market conditions going forward.

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These adjustments include the following:

Additional Confirming Indicators - In highly volatile markets, our weighting of the market's 15-week moving average may cause a much quicker signal change in market sentiment or a whipsaw effect in the strategy. To minimize this effect, we have been giving more weight to the Directional Movement Indicator (DMI). The Directional Movement Indicator is a momentum indicator that was developed by J. Welles Wilder. It is calculated comparing the current price with the previous price range, and displays the result as an upward movement line (+DI), and a downward movement line (-DI), between 0 and 100. In a highly volatile market, increasing the weighting of the DMI gives our BAMSI truer readings on the market. By back-testing the increase in weighting of the DMI we have found that the whipsaw action in the portfolio would have minimized considerably in 2010.

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Another confirming indicator that we have increased the emphasis of in our market sentiment analysis is investor sentiment produced by the American Association of Individual Investors (AAII). The AAII Sentiment Survey is a weekly poll conducted by the organization. The objective of the survey is to gauge overall sentiment of their membership of 150,000 members. The survey polls the membership's sentiment of where they think the market will be in six months (bullish, bearish, or neutral).

Because the survey is a *contrarian indicator*, when the survey shows too many investors as being bullish, the market may be near its highs. On the other hand, when there are too many bears, it often corresponds to a market low. When coupled with the BAMSI in a highly volatile market, it gives us higher conviction of signaling potential important turning points in the market. We are confident this indicator will help us identify important market bottoms more accurately and more timely even in a 2010 style volatile market environment.

Increasing number of portfolio positions – Because of the elevated market volatility in 2010, there was no clear leadership from any sectors during the year. In fact, on several occasions, what was the best performing sector one month was the worst next month *(Figure 3)*. This is reflective of investor uncertainty about the market's direction and about where to invest. This detracted from performance because we invested in a focused portfolio of 25-30 stocks in leading sectors that experienced these whipsaws.

Figure 3: Volatility of Sector Rotations in 2010 (from best to worst performing)

Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov	Dec.
Healthcare	Consumer Cyclical	Financials	Consumer Cyclical	Telecom	Utilities	Telecom	Utilities	Info Tech	Materials	Energy	Financials
Staples	Industrials	Industrials	Industrials	Staples	Healthcare	Materials	Telecom	Industrials	Info Tech	Consumer Cyclical	Materials
Industrials	Materials	Materials	Energy	Utilities	Staples	Industrials	Healthcare	Consumer Cyclical	Energy	Industrials	Energy
Financials	Financials	Consumer Cyclical	Utilities	Healthcare	Telecom	Energy	Staples	Energy	Consumer Cyclical	Materials	Telecom
Consumer Cyclical	Info Tech	Telecom	Telecom	Consumer Cyclical	Info Tech	Consumer Cyclical	Materials	Telecom	Staples	Financials	Industrials
Energy	Staples	Info Tech	Financials	Info Tech	Financials	Utilities	Consumer Cyclical	Healthcare	Industrials	Telecom	Info Tech
Utilities	Energy	Staples	Info Tech	Industrials	Energy	Info Tech	Energy	Financials	Healthcare	Staples	Healthcare
Info Tech	Telecom	Energy	Materials	Financials	Industrials	Financials	Info Tech	Materials	Financials	Info Tech	Staples
Materials	Healthcare	Healthcare	Staples	Materials	Materials	Staples	Industrials	Staples	Telecom	Healthcare	Consumer Cyclical
Telecom	Utilities	Utilities	Healthcare	Energy	Consumer Cyclical	Healthcare	Financials	Utilities	Utilities	Utilities	Utilities

Source: Bloomberg

In response to the market's lack of recent sector leadership, we have increased the number of core portfolio holdings from 25-30 stocks to 35-40 stocks with both strong fundamental and technical characteristics. This allows us to have greater diversification across multiple sectors of stocks so we will not be as impacted by sector rotation. Once the market returns to more normal market conditions where sector leadership is clearly demonstrated, we may decrease the number of core holding back to our more focused portfolio of 25-30 stocks.

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Multi-strategy portfolios – Although the All Cap Core strategy had a challenging quarter in Q3, other investment strategies we manage performed competitively versus the market. Our "Active Long/Short" strategy had good returns in 2010 while taking significantly less risk than the market. Our "Global Tactical Indexing ETF" strategy also had competitive returns in the year despite the crisis in Europe. Our strategic holdings in gold paid off handsomely as the metal gained 29% during the year. Clients who held multiple strategies in their portfolios benefitted from this diversification in 2010 and we believe it will continue to be beneficial for clients going forward.

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Why We Believe 2011 Will be a Good Year for Our Investment Strategy

We believe there is a good likelihood that 2011 will be a profitable year for the stock market and an exceptional year for our strategy. We are already seeing the adjustments in our investment approach starting to pay off.

For example, recent acquisitions to the All Cap Core portfolio like Sina Corporation (NASDAQ: SINA), a Chinese-based online media company, has produced double-digit returns for our clients due to excitement about the prospects for the company's social media services. Sina operates a "mini-blog" service in China that is similar to "Twitter" here in the U.S. This service is expected to achieve 150 million users in 2011. Micro-blogging has the potential to be the most popular social media format in China.

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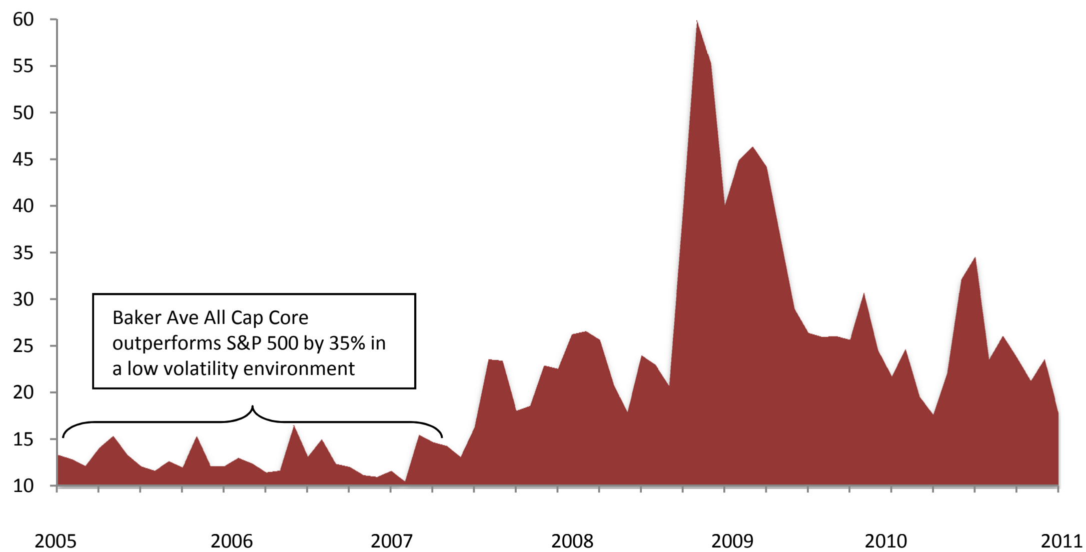
Another recent acquisition that we are excited about is Lululemon Athletica (NASDAQ: LULU). LULU designs and retails high-end athletic clothing. The company grew earnings 80% in its most recent quarter and analysts expect 82% growth in earnings year-over-year. Shortly after we purchased a position in LULU, the company raised its profit forecast resulting in a sharp gain in the shares. Analysts believe there is potential for another 20% gain in the stock from current levels.

In addition to our recent stock purchases outperforming the market, market volatility is approaching a more normalized historical level which is a good environment for investing in high relative strength stocks. In fact, years in which our strategy produced high returns versus the market indices were years in which market volatility was subdued *(Figure 4)*.

Figure 4: CBOE Volatility Index 2005-2010



Source: Bloomberg / Baker Avenue

There is also early evidence that suggests we are in the early stages of a cyclical economic recovery which is a positive development for the market. Manufacturing is rebounding, payrolls are starting to see signs of life, and consumer confidence is rebounding. For example, recent holiday sales were the strongest it has been in two years rising 4%.

Furthermore, the latter years in a presidential cycle tend to be good years for equity returns. The difference between the returns of the third year in a presidential cycle versus other years is statistically significant *(Figure 5)*. The desire for a political party to stay in office usually drives incentives to stimulate the economy and therefore asset prices before election time. 2011 will be the third year in the Obama Presidency.

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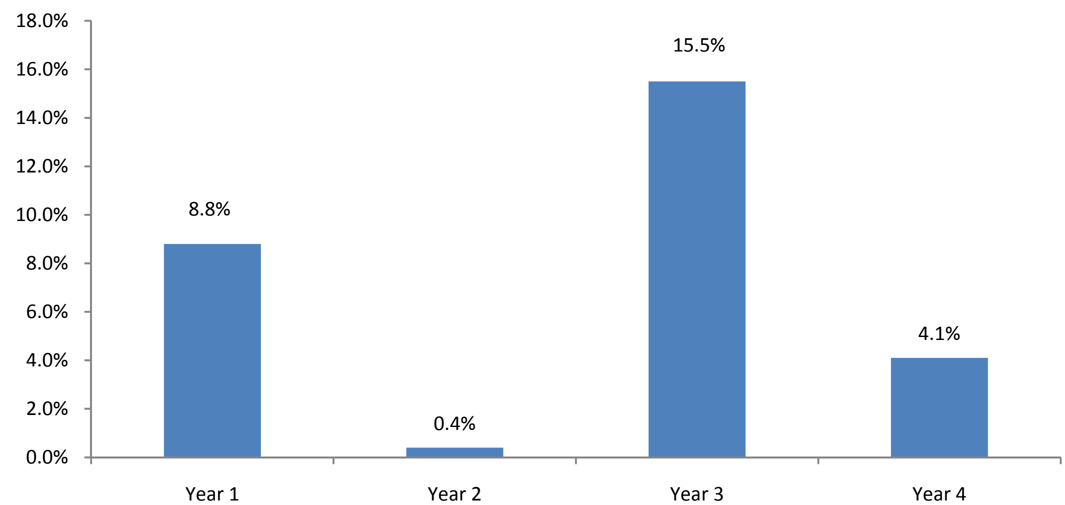
Figure 5: Average DJIA Returns by Year of Presidency (1896-2010)



Source: MarketWatch

Moreover, US corporate profit levels are about 10% higher now than those achieved in 2007, yet the market is about 10% lower than the market peak in that year *(Figure 6)*. Based on a current price-to-earnings multiple of about 15, the market appears to be reasonably valued based on historical measures of valuation.

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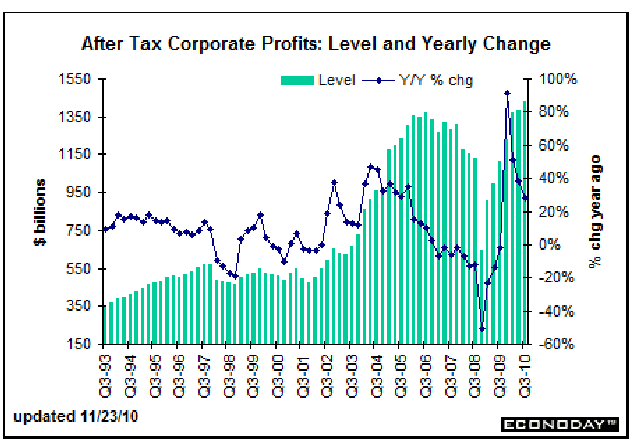
Figure 6: U.S. After-Tax Corporate Profits Continue to Rise



Source: Econoday

Don't Throw Caution to the Wind

While we have discussed how economic and market conditions have improved, we believe it still behooves investors to avoid throwing caution to the wind. Although we are likely in the middle of a *cyclical recovery*, we may be in the 5th inning of an overall larger *secular bear market cycle (Figure 7)*. While the Federal Reserve is happy to dole out liquidity to support asset prices today, it can just as easily take away the punch bowl tomorrow.

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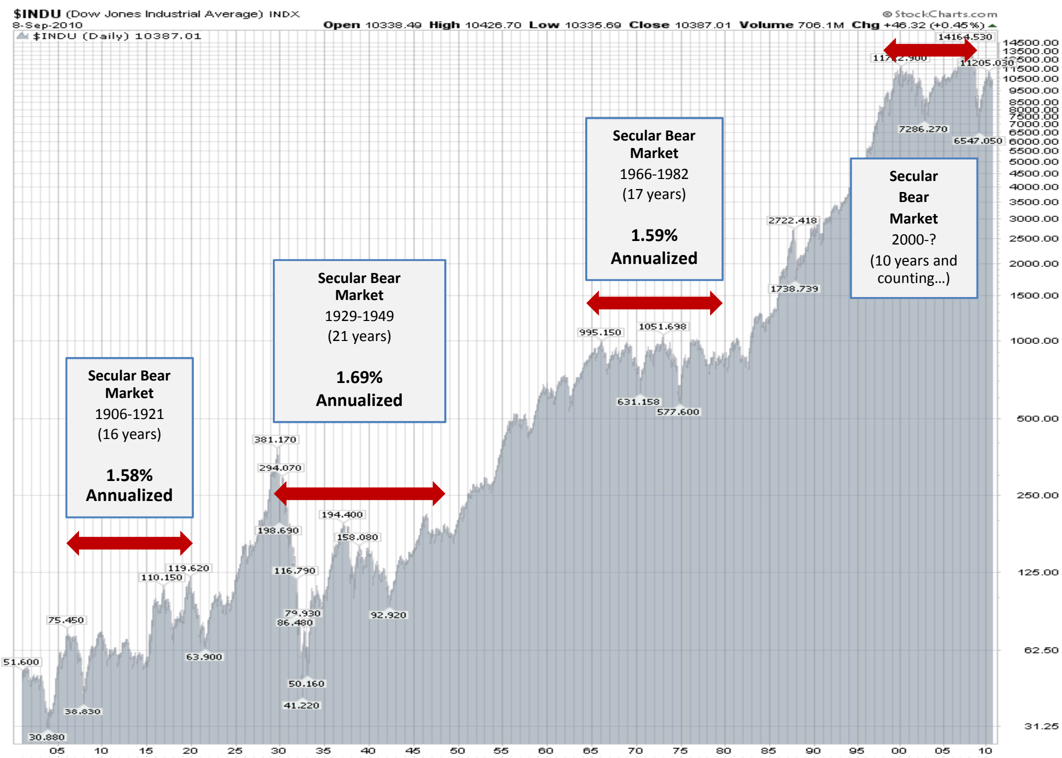
Figure 7: Historical Secular Bear Markets - Dow Jones Industrial Average 1900-2010



Source: Stockcharts.com

The roaring 80's and 90's were arguably fueled in large part by massive leveraging by both consumers and government. The new reality today is both consumers and governments are continuing to deleverage. Consumers are taking on less debt and financial institutions are less

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inclined to lend. Countries in Europe are instituting austerity measures to bring their financial houses in order. Furthermore, taxes will likely need to be raised to pay off massive debt loads. This deleveraging process will take time to unfold and will likely lead to more tepid growth and shorter and weaker "bull market runs" going forward.

Conclusion

Although recent performance has been challenging for us as investment managers, we do not believe it is reflective of the true long-term potential of our investment strategy. In light of the market's whipsaw action in 2010, we have made adjustments to our investment process that we believe will help avoid a repeat of recent performance should we see the unlikely occurrence of 2010 market conditions going forward. We are already starting to see these adjustments pay off in the 4th quarter with continued strong momentum in 2011 as evidenced by our outperformance versus the benchmarks as we write this letter. We believe there is a good likelihood that 2011 will be a profitable year for the stock market and an exceptional year for our strategy. Economic conditions are improving and market volatility is approaching more normalized levels which is an environment in which our investment approach thrives.

"The strong momentum we built up in Q4 is continuing into 2011 with outperformance versus the benchmarks."

While economic and market conditions have improved, we believe it is still important for investors to know where the "exit door" is should another 2008 style market come along. Although we are likely in the middle of a cyclical recovery now, we are likely still in a larger secular bear market cycle because of the overall deleveraging process of consumers and governments.

The strong momentum we built up in Q4 is continuing into 2011 with outperformance versus the benchmarks. We look forward to reporting back to you at the end of Q1 with additional positive news and market insights. We thank you for your continued confidence in us as stewards of your investment capital.

Sincerely,

Baker Avenue Asset Management

Disclosures

"Baker Avenue Asset Management LP ("BAAM") All Cap Core Equity Composite consists of fully discretionary fee paying accounts that invest in all cap equities and cash. Portfolios are included after one full calendar quarter under management; terminated accounts (those no longer with the firm) are included through the last full calendar quarter prior to termination. The strategy and accounts 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 against the S&P 500 (as additional information). We believe the index that best replicates the market capitalization of securities we purchase for clients in the ACC are best represented by the S&P 500. The S&P 500 Index measures the performance of 500 leading companies in leading industries of the U.S. economy, which represents over 80% of the investable U.S. equity market. The index is presented as total return (reflect reinvestment of dividends, interest and other income) and is unmanaged, cannot be invested in directly and is never comprised of a 100% cash allocation. BAAM may or may not trade in securities that are represented in these indices. No representation is made that the performance or volatility of the ACC will track or otherwise reflect a particular index.

Past performance is not indicative of future results.

The minimum account size for inclusion in the composite is $100,000. The U.S. Dollar is the currency used to express performance. Returns are presented net of a Model Advisory Fee and net of transaction costs. Returns are total return, i.e., they include the reinvestment of dividends, interest and other income. The composite includes both bundled-fee (wrap fee) and non-bundled fee portfolios. As a result, the returns presented are net of a model investment 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. For bundled accounts in the composite, this fee includes management fees, brokerage commissions, portfolio monitoring, consulting services and in some cases custodial services. The composite includes accounts that did not pay an advisory fee; since the completion of the first year, less than 2% of assets in the composite have been from non-fee paying accounts. BAAM may waive or reduce the management fee with respect to one or more clients or agree to apply a different management fee for a client. Full details of the fees charged are available in our ADV Part II, available upon request.

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.

We may move to cash at times when the risk is not appropriate. However, there is significant dispersion between the performance of our composite and the index as the index is unmanaged and cannot move to 100% cash as we may do for our clients (and thus, this is reflected in our composite). For the time periods stated below, 1/1/05 through 12/31/10, the following time periods reflect when the Composite had a 100% cash allocation as a defensive component in the ACC. As a result, the negative performance of the S&P 500 is not reflected in our performance as we did not have the market exposure. Time periods are 49 days from 9/29/05 to 11/17/05, 30 days from 3/9/07 to 4/8/07, 63 days 11/8/07 to 1/10/08, and 40 days from 2/20/09 to 4/1/09. There were 5 time periods where the cash exposure was 100% but for less than 30 days. We have examined these time periods and believe the impact is, overall, not material. In total from 1/1/05 to 12/31/10 we were in 100% cash for 346 days.

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 December 31, 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.

Supplemental information regarding this All Cap Core Strategy presented on the previous page includes performance that has not yet been verified (2010) and cumulative performance since the inception of the strategy.

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 to info@bakerave.com. 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®).

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