

2005 STOCK SELECTION REPORT CARD
THE GOOD, THE BAD AND THE UGLY

Stock	Grade	Date Of Initial Buy	Comments
Amgen	A	3/93	<p>Amgen turned in a terrific 2005. For the calendar year the stock was up 22%. Amgen, a behemoth of a biotech Company, sporting a market cap of a cool \$90 billion, \$12 billion in sales and posting 2005 results that beat street expectations throughout the year, rewarded shareholders with a stock price 23% higher than 2004's ending trade. Amgen turned 25 years old in 2005. The Company currently offers 8 products that treat grievous illnesses targeting inflammation, metabolic and bone diseases, oncology, hematology and nephrology. Amgen differentiates itself from big pharma in two ways. Their model is to introduce breakthrough products to smaller patient populations that save people's lives and that are truly life changing vs. big pharma's model of introducing moderately incremental therapeutic advances to the masses. For the full year, revenues increased 18% and earnings increased 33%. We believe the Company will continue to grow sales in the upper teens because they continue to be a market share taker, they possess an enviable pipeline, and they are introducing new indications for existing products. Amgen's 3 major blockbusters are Neupogen/Neulasta (YOY growth of 21%), Aranesp (YOY growth of 36%) and Enbrel (YOY growth of 42%). Each of these products markets are believed to be highly under penetrated. Aranesp (treats red blood cell deficiencies in chemo patients) wrangled 10 share points from Johnson & Johnson's Procrit in 2005. Late pipeline product AMG 162 (Denosumab) promises greater efficacy and better dosing (twice-yearly injections vs. daily dosing) than Merck's Fosamax in treating those afflicted with postmenopausal osteoporosis - a \$4 billion market. Other indications for Denosumab include treating those with cancer to prevent adverse skeletal events and rheumatoid arthritis. Look for Amgen to file for approval in the European Union (EU) in 2007 and their U.S. Filing in the second half of 2008. Phase III product Panitumumab (for which Amgen attained full ownership rights to with recent purchase of Abgenix) combats colorectal cancer and renal cell cancer and has been put on fast track status for approval by the FDA. Amgen optimistically estimates sales for Panitumumab at \$2 billion in peak sales for all indications. Aranesp is currently under study to treat those with chronic heart</p>

			<p>failure related to anemia - a potential \$1 billion market in addition to the \$3.2 billion in sales Aranesp currently generates. Amgen initiated Phase 3 trials which will take approximately 3 years to conclude and includes 3400 CHF patients. The Company maintains 80% gross margins, 30% net margins and reinvests 20% of sales into R&D. Valuation remains attractive given stock is trading 22X's expected 2006 earnings of \$3.70, a relative bargain compared to Genentech's 47X's consensus EPS estimate. Risks to stock in 2006 include CERA (Roche) threat, volatile Medicare reimbursement issues, and introduction of biosimilars.</p>
Apple Computer	N/A	10/05	<p>Please see 4th quarter <i>Wedgewood View</i>. for our thoughts on Apple Computer.</p>
Berkshire Hathaway	C	12/98	<p>Our 2005 forecast for share price appreciation for the shares of Berkshire Hathaway has fallen flat for the second year in a row. When we say flat we are not exaggerating: Berkshire "B" shares began 2005 at \$2,936.00. They ended the year at \$2,935.50. The most prominent development at the Company in 2005 was the "Fort Knox-like" weathering of the worst hurricane season on record - in both absolute and inflation-adjusted terms. The Company has reserved \$3 billion for hurricane related claims. To put the total cash flow generating prowess of Berkshire Hathaway into perspective, please consider, if you will, the profundity that this multi-billion dollar claim could easily be paid from the <i>non-insurance</i> operating subsidiaries of Berkshire. No other insurance Company in the world could claim, much less dream, such a thing. It is simply beyond the realm of real-world insurance Company economics to have such size, diversity and profitability on such a multi-billion scale and scope. The Company's insurance float is approaching \$50 billion. In any valuation of an insurance company, it is paramount to understand that float is a liability – but not necessarily for Berkshire. In the simplest terms, insurance Company float is accumulated premiums paid in before some amounts of unknown future claims are paid out. If an insurance Company is reasonably skilled at the business of insurance underwriting then any earnings on the invested float serves to make the entire insurance Company a pretty decent business. The reality is that most insurance companies operate as providers and suppliers of a price-sensitive commodity. Most insurance companies lose so much on the underwriting side of the business that earnings on the investment side provide just marginal overall profitability. The insurance businesses of Berkshire are a notable exception. Berkshire's overall underwriting usually generates a profit. What that means is that the cost of float to the Company is often times zero. What that <i>really</i> means is that Buffett gets to invest \$50 billion on</p>

shareholders behalf for free! Berkshire's float amounts to 55% of shareholder's equity. In addition, the Company's other significant "liability" is the \$12 billion in deferred taxes owed primarily on the Company's \$45 billion equity portfolio – another multi-billion tax-free loan for Buffett to invest. Thanks to Mr. Greenspan and his dozen or so interest rate hikes, the Company's \$45 billion in cash is now earning a risk free +\$2 billion in cash per year - the world's largest corporate elephant gun remains locked and loaded. After investing just \$3.6 billion over the course of 2003-2004, 2005 was also one of the busiest Buffett has had investing his cash hoard of late. He invested nearly \$20 billion in 2005 – equaling the \$19.8 billion in 2002. The most since 2002 Buffett's investment and operating philosophy is anathema to the standard practice of "smoothing" quarterly (or annual) earnings all too commonplace in corporate America; remember, corporate managers can report pro-forma earnings, but must sign off on GAAP required SEC filed earnings. Berkshire's growth, as measured over more appropriate time periods continues to impress. Over the past five years, both revenues and pre-tax operating earnings have tripled and cash flow has doubled. In our view, the stock has not been this cheap since Buffett offered to buy back shares in the spring in 2000 – first time he ever publicly made such an offer. We expect year-end 2006 pre-tax operating earnings of nearly \$130 per "B" share. Capitalized at a quite modest 12X values the operating side of Berkshire at about \$1,550 per share. In addition, we expect the investment side of Berkshire to end 2006 with nearly \$2,800 per "B" share in investments. Adding the operating side with the investment side yields an intrinsic value of almost \$4,400 per share. The stock is cheap! We once again (third time is a charm?) expect Berkshire Hathaway to be one of our best performing stocks in 2006.

Comcast **D** **3/04**

One of the reasons we will sell a position in our portfolio is if we believe the growth prospects of the company is compromised. We will replace it with a company we believe offers better long-term, sustainable growth. Case in point: In September, we sold our Comcast and bought Qualcomm. In our 2004 report card, we were bullish on Comcast for a myriad of reasons. We were looking for Comcast to penetrate their client base with their advanced services such as digital cable, VOD, high speed internet and VOIP. What a bundle! We believed they would increase their average revenue per user and reduce defections to satellite services. Lo and behold, what did 2005 bring? 2005 brought about the end of their monopoly on video distribution. Comcast was sold given our view that the rapid emergence of digital content over IP networks reduces the value of distributed content over broadband cable networks. Also, high speed internet offerings from companies such as Verizon which offer

lower prices for equivalent speeds or for a couple dollars more, twice the speeds of cable have shown that the competition is here to stay and will again will impose pricing pressure on these commodity products. In our eyes, their prospective growth rate is diminishing, their ability to raise prices gone and their monopoly on programming erased. Time to move on the better business - period.

Commerce Bancshares **A** **8/04**

Commerce Bancorp's 10% return to shareholders in the face of a flat yield curve earns the Company an A for the year. Not to be repetitive, our third quarter 2004 Wedgewood View entitled *1st National Bank of Wedgewood* told the Commerce story in greater detail, but we would like to reiterate a few distinguishing features of Commerce Bancorp. Commerce is a \$38 billion multi bank holding Company with 364 "stores" located primarily in the Mid-Atlantic. In 2005, they expanded into West Palm Beach, Florida with the purchase of Palm Beach County Bank in order to establish a presence in Southeast Florida. They are the 11th largest bank in the Mid-Atlantic region with aspirations to grow to the 5th largest within the next five years. Commerce, primarily an organic grower has stated its goals to build about 50 branches each year in new and existing markets. Couple this with their superior deposit gathering capabilities and their ability to take market share from their competitors and "poof", Commerce grows. The Commerce model is easy to understand: Deposit growth (36% annually over last 5 years) - drives balance sheet growth (35% growth annually over last five years) - which drives net interest income growth (33% growth annually over last five years) - which drives EPS growth (25% over last five years). There you have it. Commerce excels in their ability to attract low-cost deposits. At the heart of their corporate philosophy, they believe the customer is willing to trade off a higher deposit yield for a better banking experience. So, Commerce offers longer hours, lower fees, and a friendly and helpful staff along with convenient and highly attractive (expensive) branches. Bottom line on Commerce 2005: The flat yield curve affected their net interest margin which compressed quarter by quarter throughout 2005 and ended the year at 3.50% (compared to 4.27% in 2004). Commerce's rapid deposit growth exceeds their ability to make loans (although their loan growth remains strong relative to peers with average total loans up 30% YOY) and Commerce invests the excess in fixed income securities. Commerce does not use swaps or derivatives in order to manage their interest rate risk. The spread on their fixed-income portfolio and the rate Commerce pays on deposits was squeezed and thereby has interrupted their outstanding EPS growth record. Management expects the company's net interest margin to stabilize early next year given expectations that they Fed will be

finished raising the overnight rate by their March meeting and the yield curve will return to normal in 2006. When this happens, we look for their net interest margin to increase in 2006 resulting in more normal levels of profitability. Currently trading at 18.4X's 2006 consensus EPS estimates of \$1.85, Commerce is valued at a premium to their peers on current earnings basis, but at a substantial basis on a deposit basis. We believe 2006 consensus earnings estimates are too conservative and do not reflect (at all) the earnings leverage inherent in the Company's business model in a more normal yield curve environment. The stock in the low \$30's is cheap.

Countrywide C **8/03**
Financial

Countrywide was a very profitable investment. We were attracted to the Company because of their terrific organic growth, as well as their business diversification over the past few years. The Company has attained the remarkable status as both the nation's #1 mortgage originator and the #1 mortgage servicer without a major acquisition. That said, the concomitant generational interest rate lows over the past few years and the resulting housing boom has changed, we believe substantially, the current risk/reward profile for the Company. We exited these shares in October to initiate an investment in Apple Computer. The mortgage debt industry has, at the behest of rock bottom interest rate levels, witnessed an unprecedented growth spurt, almost tripling, from \$3.2 trillion to approximately \$8 trillion during the recent decade. Previously, mortgage equity extractions have lent GDP 25 to 50 basis points annually. However, over the last four years, equity extractions have accounted for nearly 90% of GDP! If home is where the heart is, then Countrywide Financial is certainly the money-eluding stent that has kept it pumping. (Medtronic would be proud). With their servicing portfolio eclipsing \$1 trillion and loan production ringing up double digit growth, this Company is far from having a coronary, right? Wrong. Industry wide hypertension (forgive the circulatory system references, but it is worthy to note how important this industry has been to the health of the economy--considering that sans equity extractions, GDP is a mere 0.5% -- a far cry from the reported 4%) has surfaced in the form of ghastly lending standards (anecdotal evidence has a \$30k income pulling down a \$450k mortgage without blinking) and a Fed on pace to dole out its 14th consecutive rate hike - and on target to mow down variable borrowers in kind (30% of all first mortgage originations in 2005 were ARMs). At the current level of interest rates, \$300 billion worth of ARMs are set to adjust monthly payments higher in 2006. \$1 trillion are set to adjust in 2007. In addition, housing affordability is at 20 year lows while the current inventory of unsold homes has recently exceeded 500,000 -- an all-time, if not ominous, record. In addition, Countrywide's chest pains are evidenced in the rarely-seen jettisoning of

banking assets (which deviates significantly from their stated strategy) at a time when several other companies are signaling the onset of withering margins. After what seems a fundamental over-haul to simply make bottom line estimates, paired with toxic levels of unconventional lending (a Fannie-esqe derivative blow-up waiting to happen) we decided to part ways

First Data **D** **4/03**

2005 was a disappointment for Company. Growth was sub-par and the stock, after a poor 2004, was flat on the year. However, 2006 has started with a bang. We have written in the past the Company's crown jewel is their Western Union division. Western Union is the largest money transfer company in the world - handling more than 275 million money transfers each year through its more than 271,000 agent locations in over 200 countries and territories. As this summary is being written the Company has just announced that Western Union will be split off to existing shareholders as a separate company. We applaud this move to unlock shareholder value. We will comment on our views and expectations on each business in the near future.

Gentex **A** **12/97**

With Gentex's stock "only" returning 8% in 2005 we suspect that a few clients may wonder if our annual stock selection report card self-grading methodology has become a bit too generous on grade inflation. Perhaps. But when it comes to the past year of turmoil in the U.S auto industry, and in consideration of a very successful year at Gentex on the corporate development front, we believe Gentex deserves a *Summa*. (We do promise to try to avoid the endemic grade inflation that seems to be rampant within our nation's leading colleges and universities; where the typical "Lake Woebegon" average student seems to graduate at least *Cum Laude*.) The plight of General Motors weighed on the entire U.S auto industry throughout 2005. Ironically, General Motors sold more cars in 2005 (9.17 million) than in any year over the past 27, but with a retiree health and benefit expense structure from a bygone era, the GM continues to rack up losses in the multibillions. At year end the stock of GM sat at 25 year lows. Ford Motor Company has not fared much better, as its stock sits at 20 year lows. Gentex could not completely escape the woes of U.S auto makers in 2005 either. Calendar 2005 was easily the most difficult year for the Company since our original investment in these shares in 1997. Despite the fact that the Company made notable progress on the international front, and on new product development, General Motors, Ford and Chrysler still accounted for 40% of the Company's 2005 sales. (Though down from 70% in 1999.) Of the Big Three, the most notable market share declines was General Motors' car market share plunge to 20% from 28% in 2004 and Ford's

car market share drop to 11% from 15%. In addition, Ford's truck market share has dropped over the past two years from 28% to 21%. The good news is that Gentex's offshore auto-dimming mirror units are growing in excess of 20%. They continue to benefit in two key areas – new offshore auto platforms (11 new offshore mirror platforms versus just two U.S. new mirror platforms in 2005) and offshore market share gains. The Company currently has 80% market share of the global auto-dimming mirror market. The global potential for auto-dimming mirrors is still vast. Consider the following: There are approximately 60 million light vehicles produced annually across the globe. Interior auto-dimming mirrors have currently penetrated as much as 30% of autos in North America, about 15% in Europe and just a single digit in Asia/Pacific. The Company's mirrors are offered on nearly all of Toyota's North America vehicle line-up. Significant mirror platforms have increased at Nissan, BMW, Mercedes and Volkswagen/Audi. The Company supplies mirrors to 10 current Chrysler models and recently won a contract to supply all of Chrysler's mirrors through 2009. Given the inherent and recognized safety features (and multiple mirror content features and applications), plus a continued increase of high-mounted headlamps on light trucks and SUVs, increased usage of blue-violet hue HID (high intensity discharge) headlamps, larger exterior mirrors and a glare-sensitive aging driver population, it is not unreasonable to assume maximum annual auto-dimming mirror penetration rates of 50% over the next 10-12 years. At \$100 per mirror, the global market potential could be between \$2.5 and \$3 billion annually. For perspective, the Company's current annual revenue run rate is just north of \$500 million. The Company's illustrious auto-dimming mirror franchise will continue to have a very bright future. (A pun is lurking somewhere here.) That said, the Company has just embarked on a new product which could be even more significant than the bountiful auto-dimming mirror. We of course are referring to the Company's nascent auto-dimming headlight product (formally: SmartBeam Intelligent High-Beam Headlight Assist System). As a significant safety feature driver controlled manual high-beam usage is estimated to be properly deployed only 25% of the time. Research has shown that at 50 miles per hour most autos are out-driving their pattern of low beam light. SmartBeam uses a semiconductor-based light sensor to distinguish between white light (headlamps) and red light (taillights). In addition, patented sensors filter and distinguish street and other AC light from vehicle DC light sources, preventing unnecessary dimming. SmartBeam automatically fades high-beams in and out. This novel technology was ranked #1 in the J.D. Power 2003 U.S. Automotive Emerging Technologies Study. Furthermore, in J.D. Power's 2004 Study, "...71% of consumers are definitely or probably interested in an Adaptive Headlight Assist System." The third model year for SmartBeam will be in the 2007 model

year. The Company expects to have access to one million units of vehicle production by then. Lastly, the long promise of expanding the Company's auto-dimming intellectual property beyond automobiles has finally arrived. The Company recently announced that Boeing will outfit their future 787 passenger window compartments with auto-dimming windows. Boeing currently has orders for 291 787s. While calendar 2005 will be a flat year of earnings growth, the Company is still a paragon of profitability. Operating margins of 30% are *six times* the industry average. Return on capital is 50%. With \$2.50 of cash per share on the balance sheet, management began repurchasing shares late in 2005 – first time in years. We expect 2006 will bring a resumption of double-digit growth for Gentex. We remain bullish.

Home Depot C+ 5/95

We began the year with muted expectations for the stock after stellar returns in both 2003 and 2004. In fact, Home Depot was the only stock in the Dow Jones Industrial Average that grew earnings by 20% in 2002, 2003 and 2004. 2005 earnings will fall short of this mark, but will still be up a terrific +18%. Since the inception of the Company's share repurchase program in late 2002, they have repurchased about 12% of their outstanding shares, amounting to 272 million shares, or \$9.5 billion of their \$11 billion Board authorization. During this same period, they have more than doubled the dividends paid to shareholders, so together, this represents over 60% of cumulative earnings that have been returned back to shareholders over that time frame. In the United States, the Company's core business is represented by about a \$200 billion DIY (do-it-yourself) market and a \$110 billion supply opportunity, just labor alone. Looking outside the United States, the DIY market exceeds about \$250 billion. Home Depot is number one in Canada with sales of about \$5 billion in Canadian dollars. They have stores in every province. The Company has gone from zero to number one in Mexico in just three years with sales there approaching \$1 billion. As a result, Home Depot is now the number one home improvement Company across North America. As the Bear case for housing gained traction during 2005, Home Depot's stock performance could not have mimicked the housing market's sentiments any better (worse), conceding a lackluster -5% return. But despite the Big Orange Box's 2005 struggle in the stock market, the business reliably produced what has turned out to be double digit top line growth, all in the face of a seemingly market crippling housing stall. Management is ever prescient of the current condition (and sentiments) surrounding the direction of the home building market and, in response, issued a five year strategic plan -- growth estimates and all (a 14% 5-year growth rate). Immediately our antennas went up (as should yours). It is always an anomaly when any Company's management issues such

long term guidance (aside: Medtronic issued a similar time-framed guidance during 2005), because, rotten truth be told, most management cannot see their business (or at least have the confidence) that far in advance (to many, even a few quarters is a stretch). But HD's plan comes as little surprise, given the outstanding track record and skillful maneuvering that Home Depot's management, under Draco-like Bob Nardelli, has exhibited during the last half-decade. First on their agenda seems to be the sidestepping or at least the leaning away, from housing. This will be a critical step for HD going forward. Hughes Supply is a defining acquisition in Home Depot's history. It will position the Company as the number one U.S. diversified wholesale distributor with next year's sales approaching \$12 billion. It is also where we see the little known, but hardly little, Home Depot Supply business catalyzing much of the future growth. Lending a brief background to HD Supply: they are a leading supplier of maintenance repair and replacement products to owners and managers of multifamily, hospitality and commercial properties as well as (and almost more importantly) contractors, municipalities and maintenance professionals—simply put, they cater to professionals. In addition, HD Supply's size was recently doubled from 450 stores when they acquired Hughes Supply, a wholesale distributor that operates in the same vein. But more importantly, this acquisition is clear cut evidence that management is actively moving away from being a housing-only, big box retailer. Within the core DIY home improvement market of \$200 billion, and according to Home Improvement Research Institute, home improvement spending is driven by three factors. First, about 40 billion or 20% of the spending is driven by housing turnover. Second, almost \$50 billion of the spending is driven by refurbishment as a result of the age of homes. Third, more than \$100 billion is driven by disposable income. In the past, HD retail stores were opened at a break-neck rate of almost 150 stores per year! (Apple has about 150 stores total!) However, true to their plan, new store openings will be scaled back to a more modest (at least to Home Depot) rate of 90-100 new stores per year. More likely, than not, the re-allocated cash will be funneled towards the cultivation of the professional wing. The bourgeoning of HD Supply is slated by management to be 20% of total sales by 2010. The professional market (\$400 billion) is double the size of the Company's traditional do-it-yourself market. If this is indeed the case, HD certainly has opened a new avenue in which multiple expansion is possible, regardless of how the housing market fairs. We expect the Company to earn about \$3.10 per share in 2006. At the current share price (\$40), we believe the stock is quite attractive valued at just 13X.

IMS Health	C	2/04	<p>The holding of IMS Health in our portfolios came to an abrupt end in July when the Company received an offer to merge with VNU NV - a leading global information and media company located in the Netherlands. We felt the premium offered for the shares was too low and we did not want to own VNU NV. While our short holding of IMS Health did not produce the type of returns we were looking for, we were able to replace IMS Health with Varian Medical Systems which was an excellent performer in the second half of 2005.</p>
Juniper Networks	N/A	6/05	<p>From time to time we revisit stocks that we previously owned. Such was the case when we invested once again in the shares of Juniper Networks this past June. For those who may be unfamiliar with the Company, a brief primer is in order. Juniper makes routers. Routers are computer-like (application specific microprocessors and software) devices that are a critical component in the design, operation and expansion of data networks. The most familiar data network is the Internet, or World Wide Web. "Web" is an apt visual in understanding how a router is integral to connecting a "web" of disparate data communications lines into an integrated network. A router is simply a "connecting traffic cop" at key intersections of a network. Anytime data is sent over a network, whether it is an e-mail, music download, a video stream, a file download, or just simply web browsing, such data is sent in packets of digital bits (zeros and ones). The packet of data is assigned a forwarding address (and increasingly a level of security) and sent on its way. Unlike previous generations of telecom networks where each communication had a dedicated, unbroken line of communication, current data networks often break apart traveling data packets and then are subsequently "routed" in the most efficient pathway only to be reassembled at the final destination. Current data networks (DSL, cable and wireless) send packets of data at increasingly blazing rates of speed. The fastest consumer oriented networks have reached speeds of 10 Mbps – or 10 mega bytes per second. Juniper Networks has a famous (and infamous) history. Juniper Networks is famous as the start up Company in 1996 that crashed into the core router market (backbone infrastructure of global data networks) and creating a duopoly with Cisco Systems. Infamous in that our earliest investments in the stock (not the Company) did not avoid the final brutal stages of the 2000-2002 nuclear winters. So why invest in Juniper Networks again? The first reason is industry specific. Simply put the demand for and the growth of data networks of multiple sorts has grown unabated. We expect the infrastructure build in core networks to continue to be lumpy quarter-to-quarter, but to double every two to three years. Telecom carriers continue to migrate legacy circuit-based networks over to</p>

the latest generation of IP (Internet Protocol) packet-based networks. Telecom carriers and cable companies are bundling voice, data and video over a single industry standard IP network. Wireless companies are rapidly getting into the act to as data connections speeds increase within their 3G (3rd generation) networks. As these networks proliferate on a global scale, the demand for routers in both the core and edge of networks will increase as well. The signposts of such profligate demand are every where. From 1 billion global text messages sent every day, to the 850 million songs, plus the 8 million videos downloaded from Apple's iTunes Music Store, to the very recent announcement that CBS will simultaneously broadcast the upcoming NCAA basketball tournament and stream the video over the Internet. (An IP Network aside: TV quality video streaming consumes **100 times** the network bandwidth as regular broadband browsing does!) The RBOC's are just beginning to rollout their high-speed fiber connections. The speed/pricing equation for these offerings is astounding. Verizon's latest is a 20% discount to cable at 5 Mbps, \$45 a month for 15 Mbps and 30 Mbps is available for just \$180. (Where do we sign up??). The second reason to invest in these shares is the fact that Juniper has become a more diverse Company over the past few years. The Company's product line now spans numerous iterations from core routers to edge routers, plus complimentary data traffic management and network security systems. We expect the Company's current market share to remain steady over the next few years. Core routing is growing at +20% rates, while edge routing is growing at +30% annual rates. We expect the Company to earn about \$.90 in 2006. The stock in the below \$20 is cheap.

Legg Mason A 9/02

Legg Mason changed forever in 2005. Wall Street applauded. The stock has been one of the best performers in our careers. Since our initial investment in the Fall of 2002, these shares have increased from a split-adjusted price of \$30 to \$130. Legg Mason has been on a mission for years to transform itself from an old-line, commission-based brokerage firm and into a fee-based money manager. The firm's CEO, Chip Mason, took – and kept - the early industry lead preaching that commissions were “out;” and fees are “in.” For years the Company has far outpaced their competitors in generating fees from asset management (as a percent of firm revenues), rather than transaction oriented commissions. On December 1, 2005, the Company announced that it has completed its strategic transaction with Citigroup, according to which it has acquired substantially all of Citigroup's worldwide asset management business in exchange for Legg Mason's private client brokerage and capital markets businesses. The predecessor firm opened its doors as a broker-dealer in 1899; many years later in 1970 Mason &

Co. merged with Legg & Co.; the Company would go public in 1983 with assets of \$30 million; and eventually would complete the acquisition of Citigroup's asset manager in 2005. The Company now manages \$850 billion. Legg Mason has been most unique in that its in-house asset manager (Legg Mason Capital Management) is one of the best in the business; in addition, the Company has been uniquely successful in purchasing best-of-breed asset management over the years. These B.O.B. firms have been allowed to keep their respective firm names, investment philosophy and operational autonomy. (We would list these firms by name, but for blatantly selfish reasons, we choose not too☺) With quite a bit on their corporate plate, 2006 will be a year of integration for the Company. We will have more to say on the "new" Legg Mason later this year.

Linear **D** **5/96**
Technology

Those clients who have invested with us more than a few years have come to learn that the disconnect between stock prices and business fundamentals is most often acute within the semiconductor industry. And so it was in 2005 with Linear Technology. For the year, the stock fell -6.0%. Linear's business, on the other hand, turned in a "typical Linear-like" performance. The greatest sin in the craft of investing is the failure to control one's emotions. This failure manifests itself in the desire to buy those stocks that are universally loved, as well as the desire to sell those stocks which are universally loathed. We admit that, at a minimum, we have been smitten with Linear's unparalleled business model since day one (1996). Linear's business model is a rarity whereby the Company earns a very high profit (gross margin: 78%!) on each product sold (think Mercedes cars) and turns over their asset base rapidly (think grocery store). What is it about Linear's business that makes such an economic marvel possible? Simply put, analog semiconductors (particularly high-performance analog semiconductors) have not only become part and parcel, but a driver, of nearly all advancements in our increasingly digital world. Analog (or linear) semiconductors have a critical and necessary symbiotic relationship and interaction with all things digital. High-performance analog semiconductors are proprietary, product design specific. These countless products (Linear designs 7,500 products for over 15,000 worldwide OEMs), which on average sell for just \$1.40, enjoy long product life-cycles – a rarity in the technology world, much less the world of semiconductors. Just a handful of companies compete in the high-performance analog semiconductor field. Linear is (consistently) the best. For fiscal 2005 (June), the Company grew revenues 30% and net income 32%. The Company's free cash flow as a percent of sales was an astounding 41%. As testimony to the Company's staggering profitability, FCF/Sales has averaged 46% and 44% over the past five and ten years, respectively.

Furthermore, the Company has achieved 79 consecutive quarters with positive free cash flow and 43 consecutive quarters with pre-tax profits exceeding 50% of revenues! Non-cash return on equity in fiscal 2005 was an unheard of 234%. (If you know of a more profitable company, please call us.) For calendar 2006, we expect the Company to earn \$1.60 per share. At year-end 2005 the stock (\$36) was valued at 22X our 2006 earnings expectation and 19X ex-cash. We believe the stock should sell closer to \$50 by year-end 2006.

MBNA C 6/00

MBNA exited our portfolio in June, after a half-decade long and fairly profitable stint. Bank of America took over the reigns in June in a cash and stock buyout as MBNA simply fell behind the curve while their business model was ravaged by the rush of credit card prepayments (courtesy of record low mortgage rates and home equity cash outs...see CFC). Given our current Commerce Bancorp position vs. B of A's sub par deposit and loan growth rate, we decided to jettison our MBNA positions upon the release of the buyout news. The proceeds funded new positions in Procter & Gamble as well as Varian. (As a side note: negotiations for a buyout almost fell through, by virtue of the executive helicopter, transporting the entire executive team, including CEO Bruce Hammonds, crashed into the East River in Manhattan, all on board survived.)

Medtronic A 1/05

Medtronic is the global leader in some of the fastest growing medical technology markets with products and therapies focusing on cardiac rhythm management (CRM), the spine, diabetes and neuromodulation. Medtronic has made an effort to diversify away from their dependence on the CRM market and has developed products in a number of markets. They are the market leader in almost all of the markets in which they compete - with many of their markets large and under-penetrated. For example, CRM and the spinal product line represent 50% of Medtronic's 2005 revenue total of \$10.76 billion, but the U.S. penetration rate for these two markets combined is 44%. The stock returned 17% for the year outpacing the lowly Med-Tech composite return of -5%. We wrote extensively about Medtronic in our 1st quarter 2005 client report, so we will only touch on the latest quarter's financial results, their market share gains, pipeline products and forward guidance. Medtronic reported revenues of \$2.76 billion for the quarter ending October 2005, which was a YOY increase of 15%. Their net earnings grew 23% and EPS grew 23% to \$0.54. U.S. revenues comprised 68% of the overall revenue total. Medtronic captured 55% of the ICD market in their latest quarter, benefiting from Guidant's ICD problems. In addition, they currently enjoy a 40% share in the fast growing spinal market, 65% share in diabetes, and 45% shares in neuromodulation. On the verge of a new

product cycle, pipeline products to be released over the next three years include Endeavor, their drug-eluting stent, three artificial spinal discs (Company will be first to introduce a cervical disc in North America), a continuous glucose monitoring system for diabetes and various next-generation implantable cardioverter-defibrillators (ICD's). Medtronic spends 10% of revenues on research and development to maintain their competitive edge and to maintain their goal of 15% annual sales growth. The Company is very profitable with ROE for 2005 above 18% and free cash flow 20% of revenues. Medtronic is currently trading at 24x's 06 EPS consensus estimates if \$2.20 per share. This is below the 10-year historical forward multiple 32X - a 25% discount. The Company is also trading below its 10-year historical average premium to the large cap Med-Tech group. (21% vs. 30%) Medtronic continues to be a leader and we believe the Company can continue to produce EPS growth of 15% over the next 5 years given their strong pipeline and the under-penetrated, yet fast growing markets in which they compete.

Microsoft **C** **6/00**

We are often asked, "Is Microsoft still a growth Company?" We will let you decide. Microsoft's 1Q 2006 (Sept 30) results were in line with the Company producing total revenue of \$9.7 billion and earnings of \$0.31 per share. Share repurchases for the quarter amounted to \$3.12 billion with the Company retiring 114 million common shares. With \$50 billion in cash and equivalents on the balance sheet, Microsoft announced that they plan to complete their \$19 billion share buyback by the end of calendar 2006 (twice as fast as previously planned) - returning \$3.8 billion to shareholders per quarter over the next 5 quarters. They issued guidance for fiscal 2006 which ends June 30th of 11% YOY revenue growth to roughly \$44 billion - including 2006 GAAP EPS of \$1.26-\$1.30. They also raised their dividend to .36 per share for a yield of 1.4%. ROIC for 2005 was 60%. The stock is currently trading at 19X 2006 expected EPS, a discount of 13% to its peer group and 17X 2007 expected GAAP EPS estimates of \$1.49. As a side note, we are in the fourth year of the current bull market which is a time when tech stocks with lower P/E's have done well. Budgeting a \$40 billion top line is quite a feat, but Microsoft is currently in the midst of their most impressive multi-year product launch cycle in the Company's history. We expect Microsoft to grow 12-15% over the next 3-5 years. For simplicity sake, the Company is divided into 7 operating segments (although a corporate reorg. took place in 2005 and there are currently three divisions). The PC centric divisions include Client and Information Worker. Together they produce about 60% of Microsoft's \$40 billion revenues with 80% gross margins and together they are expected to grow at about a 9.5% clip over the next couple

of years. Propelling that growth is "Vista" which is expected to be rolled out in 2006. The Microsoft operating system is found on 90% of the PC's worldwide and this is the first update to the Window operating system in 5 years. Much to the chagrin of Mac users, updates on Vista include items found currently on MAC OS X such as widgets, a 3-D application switcher, photo organization and global fast search. Other updates include sideshow, slideshows with movies, stacks and thumbnail tabbed browsing. It is expected that Vista alone will generate \$8 billion in revenues over the next 5 years. Office 12 is also expected to be rolled out in the 2nd half of 2006. In response to competitive pressures from the likes of Google, Yahoo! and salesforce.com, Microsoft has offered "Live Software" or ON Demand software with the rollout of Windows Live and Office Live which are software programs for businesses delivered over the Internet or through corporate networks. These are primarily an ad supported revenue model. Currently, the worldwide online ad market is about \$15 billion and estimates expect this to grow to \$35 billion by 2009. Per Precursor Group, the key to understanding MSFT's strategy and how it differs from Google and others is that it's Microsoft "software and services" not just "software as a service". With this service, Microsoft will also be able to speed delivery of technical improvements rather than having to wait for major upgrades as it has done in the past. The remaining 40% of Microsoft's revenues are generated by their Server, Home & Entertainment, Mobile and MSN divisions. These divisions constitute some of the most exciting growth prospects given the enormity of their markets and taken together, these divisions are expected to grow at 17% over the next couple of years. Microsoft currently controls over 60% of the enterprise server market (a market MSFT entered 10 years ago) and this is a huge revenue generator at 25% of revenues. Their latest update, SQL Server was released in 2005. Microsoft spent \$4 billion dollars developing the X-box 360 console system which they released in November 2005. Ten million consoles are expected to be sold by the end of 2006. The Company actually loses \$100 per unit sold and makes about \$25 per game sold. In effect, Microsoft needs to sell 4 games per unit to breakeven. The Xbox 360 is a powerful machine that delivers on gaming and as a home media system. Not only are graphics extremely detailed, it also can play DVD's, offers free unlimited phone calls to other Xbox owners when connected to a cable modem or DSL line, allows a digital camera to be plugged in to show photos on the TV, allows an iPod to be plugged in to listen to favorite music whether playing a game or not and can even play an old-fashioned CD. Given the proliferation of high speed broadband connections, portable hand held devices are used to play music, watch video and download content, Microsoft is positioned with its Mobile 5.0 OS that allows push e-mail services and EV-DO service from Verizon. This system is

currently used in Palm's recently launched Treo 700w. Microsoft also just announced partnerships with MCI to deliver consumer PC-to-phone calling and a partnership with MTV to jointly market "URGE"- a new music downloading service. IPTV? Yep, Microsoft is selling their IPTV product line with commercial agreements already in place with AT&T, BT, and Swisscom. The X-Box console along with Windows Mobile for Portable Devices, Windows Media Center and the IPTV platform are part of MSFT's strategy to be at the hub of the digital home. Rather than a lumbering giant we see Microsoft more as a lion in the African Serengeti stalking its prey and waiting to pounce. Microsoft generates \$1.3 billion in free cash flow per month and has an annual R&D budget of \$6-\$7 billion. All in all Microsoft, is uniquely positioned spanning the PC, laptop, cell phone, game console, the server and the Web and can use its common technology and tools to deploy software and services across this infrastructure. With the stock at a modest valuation on the eve of multiple product launches, a huge cash position, stock repurchases and a moat around their Windows and Office products, we feel 2006 may play out to be a nice year for Microsoft shareholders.

Nextel **B** **3/96**

Sprint Nextel is the legacy holding (by design) that stemmed from our original positions in Nextel. During the past few years, as the communications industry began a mad dash towards consolidation, we have witnessed a veritable onslaught of wireless companies go to wireline and wireline companies go wireless. Sprint Nextel - all the while - was wireless, stayed wireless, and has never looked back. The recently completed merger between Sprint and Nextel has resulted in the third largest wireless subscriber book totaling 48 million (roughly 18 million came from Sprint). Our first glimpse of the Company's performance revealed double digit operating earnings growth, along with a healthy 1+million subscriber adds (much more to be seen once the dust settles). Subsequently, Sprint Nextel embarked on a much lauded joint venture with the largest domestic cable companies (Comcast, Cox, Time Warner & Advance/Newhouse), affording Cable the opportunity to offer the vaunted, churn busting "quadruple play" (TV, data, phone, and now, wireless). The cable "consortium" involved has a footprint of about 75 million homes (190 million people or 65% of the US population). Given that most cable customers, who are tied to their provider's current "triple play," always yearn for a more simplified personal financial structure (a.k.a. one bill, one check); the next logical step for the customer would be to pick up the convenient wireless services offered through the JV, reducing paperwork and, more importantly, reducing customer service down to a single contact (the terms of the JV state that the cable providers have been compensated by Sprint Nextel to assume customer service duties for the entire bundle). In

addition, cable content will naturally be available for wireless users to stream over Sprint Nextel's recently rolled out Power Vision Network. The Company's PV Network operates over a EVDO (Evolution Data Only—quickly being adopted by CDMA – see QCOM) protocol, commonly referred to as wireless broadband, and can stream television quality content over a wireless HD. Power Vision currently offers 8 channels and users are charged \$30 for unlimited use (subsequent variable use packages range from \$25 down to \$10). But given the rich content that cable will be able to offer over the PV Network, pricing could certainly increase (or at least remain sticky). As for exactly how many subs will S pick up, take this into account: the cable industry's average broadband penetration (video customers that also get internet) is about 40% and the more recent (within the last year and a half) telephone service has had an average of 15% penetration. This translates into a 25+million (52%) sub growth in the first year alone (to be conservative, cut those numbers in half, and you still have a wireless juggernaut). Marketing for this landmark convergence campaign will begin in the second half of '06. But the RBOC's (Regional Bell Operating Companies), can't be too far behind right? Not really. So far, the RBOC's all encompassing quadruple play is one peg short and two to three years away (light years in technology time) as they struggle to expand their networks in order to facilitate the massive traffic created by video over phone lines. For Sprint Nextel, going forward, the Company has the best spectrum portfolio, the most optimized parallel networks and the most integration on handsets. We remain very bullish at current valuations of 15x forward earnings and look to continue overweighting through the mid 20's.

Paychex

A

4/01

After Paychex's lackluster 2004 performance, coming into 2005 we had high expectations. Paychex did not disappoint, turning in a 14% return, almost triple the market's return. This return was, in part, catalyzed by double digit top (15%) and bottom (30%) line, year over year growth. It seems that much of Paychex's business (whose core is payroll data processing and HR outsourcing) performance has, at times, depended on a couple of extremely cyclical events: most obvious –employment and, believe it or not, interest rates (but they're not a Financial). Knee jerk reaction would almost always equate low interest rates with a positive company (& typically, stock) performance, recently evidenced by the market's 2003 and 2004 returns. On the contrary, Paychex reaps fatter gains (virtually risk free) when rates are on the rise. Much like an insurance company invests float, Paychex can invest (usually short term) escrowed client funds that are held for payroll distribution. Since June of 2004, we have witnessed (often painstakingly) the Fed crank short term interest rates by 325 basis points. However, during almost that same time period (Nov. 04 to Nov. 05), Paychex witnessed its interest on funds held for clients (it has its own line item) nearly double! Given that the interest is risk-free, and the product of a market investment, margins on these gains are inherently extremely high (read: 100%). Where IOFHFC shows up as a drop in the revenue bucket (3%), it turns into a gusher midway down the P&L statement, representing about 15% of '05 operating earnings. But 30% growth can hardly be attributed to simply interest earned. After all, the bulk (95%) of Paychex's revenue is derived from growth in their payroll and HR service fees. Much of these fees are derived from their dominance of the small employer (average 14 employees) market. Given Paychex's long standing position in the small business market, they have built an unassailable market position, with a client count of roughly 522,000. Larger players (ADP) tend to focus on major market services (which focus on businesses with 50+ employees) and tend to shy away from small business, as they do not efficiently fit into their large scale marketing and distribution frameworks. Paychex saw HR revenues jump over 30% from a year ago while enjoying a modest 10% increase in payroll services. Once the dust had settled, Paychex walked away from 2005 with a ROIC of over 30%, an ROE of 27% (a non-cash ROE of almost 60%) and managed to increase their dividend 25% and yield a sector leading 1.7% (just ahead of ADP's 1.6%). Going into 2006, we think Paychex is as well positioned as any to continue their double digit growth streak.

**Proctor &
Gamble**

N/A

8/05

A recent (pre-hurricane season) addition to the Wedgewood portfolio is Procter and Gamble. When a Company cultivates 10% to 15% consistent free cash flow growth, 50% gross margins, ROE in excess of 50% (not to mention non-cash ROE in excess of 100%) and almost two dozen , billion-dollar, product lines, their business, surely, must revolve around some type of mouse Googlilian click count? Not exactly. Procter and Gamble (much to tech-land's chagrin) is the domineering consumer product giant that has, and recently with the help of a company called Gillette, continuously unleashed growth by offering a barrage of high quality consumer products via the exploitation of multiple, well-established, global distribution channels. Simply put - kitchens, bathrooms, medicine cabinets, garages and pantries around the globe are likely to be stocked with multiple Company branded products, products that are available at your nearest grocery store. The Company offers over 300 products, some of which, namely their better known brands, include: *Pampers, Charmin, Bounty, Crest, Scope, Vicks, Tide, Downy, Folgers, Pringles, Cover Girl, Old Spice, Pantene, Clairol, Olay, Duracell, Braun and Gillette Mach 3*. Getting back to PG and G -- the recent half decade has certainly scarred investors with respect to mega-mergers. It is estimated as much as \$220 billion in equity has gone up in smoke at the hand of ill-fated corporate matrimones. However, the recent acquisition of Gillette has no doubt promptly begun to add value for the Company, with the eventuality of the combination being a \$65 billion in revenue-per-year juggernaut. A more robust product arsenal has already emerged and immediately siphoned away shares in several markets. Consumers usually desire that their local grocery store be an oasis of product choice and fair, if not, at least offer competitive pricing. However, your friendly neighborhood grocery store is a jungle to consumer product manufacturers. The cry of this jungle is simple; market share equals profits. The post PG-G product lineup is unparalleled. The most notable addition to PG's lineup is, obviously, the Gillette razor series. With Gillette, PG now controls almost 70% of the lucrative (40%+ net margins) global razors and blades market. This line alone will account for almost 15% of the Company's total revenue. Other notable market takeovers/consolidations include: oral hygiene with Crest and Oral B/Rembrandt commanding over 80% of this market; deodorant/antiperspirants market with 45% share, thanks to PG's Old Spice and Gillette's Right Guard. On a macro scale, PG will now be able to exert considerably more selling power, especially when jousting with the Wal-Marts of the world, further marginalizing smaller competitors. PG is indeed a classic addition to our portfolio as this titan will certainly not need an economic tailwind to generate double digit growth. Initial positions were added in the mid 50's, we are buyers into the low to mid 60's.

Qualcomm **N/A** **12/05**

Qualcomm is our most recent addition. We sold Comcast to fund partial positions in the stock. We will have much more to say about this remarkable company in our first quarter 2006 *Wedgewood View*.

SLM Corp. **B** **3/04**

SLM Corporation, the leader in student lending for over 30 years, returned 4.9% to shareholders in 2005, underperforming the broader Russell 1000 Growth Index by .33%. SLM currently has \$120 billion in managed loans which have been extended to over 8 million borrowers. Services offered by SLM assist students through the entire life cycle of the loan starting with origination, disbursement, servicing and collecting the loan. Student lending is a growth business with the costs of education growing at 2-3 times the rate of inflation and enrollment expected to rise 12% over the next decade. As we mentioned in our 3rd quarter 2004 client letter, SLM became a private company in 2004 after 32 years as a GSE (government sponsored enterprise). Revenues are derived from both interest income and fees. SLM benefits from having a diverse revenue base in which fee income covers 85% of their operating expenses. Revenues are generated as follows: 51% from the Federal Family Education Loan Program (FFELP), 16% from their Private Loan Program, 18% from Debt Management Operations (DMO) (Education and Consumer Finance), 5% Guarantor Services, 10% Other. Through their internally marketed brands, SLM dominates the campus-based lending area employing 430 salespeople that work with over 6000 schools. Maintaining strong relationships and offering strong service, stability and product mix has been advantageous to SLM allowing them to become the market leader in government guaranteed student loans. The FFELP competes directly with government sponsored Federal Direct Loan Program and currently has a 27% share of the market. What is unique about the FFELP is that the government guarantees student loans by accredited lenders and in effect guarantees 100% of SLM student loans under the FFELP program. (Due to their status as an excellent performer as rated by the government in regard to loan servicing). Interest rate risk is also mitigated because the government guarantees fixed spreads over market interest rates and the Company funds its assets and liabilities with net interest margins remaining stable in most rate environments. SLM is able to leverage their balance sheet due to low exposure to interest and credit risk thereby producing a 5-year ROE of over 33%. SLM currently has 87% of their managed loans or @ \$105 billion in the FFELP program. The remaining \$15 billion in loans are non-government guaranteed loans that have been made through their Private Loan program. Private loans are used to bridge the gap between the cost of attendance and the federal lending limit of \$17,125. Private education loans are the fastest-

growing segment within student lending and SLM has grown its private loan portfolio at a compound annual growth rate of 41% over the past four years. Thirty-two percent of these loans are made to graduate students and do not carry a government guarantee, but SLM attempts to minimize risk through the credit quality of the borrowers. FICO scores to these borrowers average 700. SLM, through their DMO division, submitted a proposal in November to the government to help collect the \$120 billion of unpaid taxes. This is an \$8 billion contract which will be split between 3 collectors. The IRS is expected to respond around February 15th. SLM will always have to contend with the Higher Education Act (HEA) which is a federal law that governs the administration of higher education programs. It must be reauthorized by Congress approximately every five years. Currently, lawmakers are finalizing bills for the next reauthorization which will be completed in early 2006 and SLM has found this reauthorization less difficult than past reauthorizations. Concerns as to which party is in the White House always affect the valuation of SLM given one party is likely to favor a government sponsored program vs. a highly profitable private organization. SLM Corporation is perceived to be a hybrid of a financial services company and a transaction processor. Given its higher expected growth rate, lower perceived risk, and insensitivity to economic cycles, SLM trades at a 5% premium to transaction processors and a 25% premium to processor banks. SLM is currently valued at 19.4x's 2006 EPS estimates of \$2.99. We look for SLM's multiple to expand in 2006. SLM is the best positioned company in the student lending arena and we look for continued EPS growth in the high-teens due to strong growth in the FFELP program and private loans, expanding DMO fees, increasing student loan spreads and the removal of the overhang from HEA reauthorization.

Sysco **F** **9/04**

Although Sysco turned in a grim -17% return for 2005, this does not necessarily mean their competitors have unveiled new, alternative sources of sustenance, rendering traditional, edible food obsolete (unlike the fast paced technology hares). Rather, part of this return can be attributed to the fact that the Company's real sales growth, during fiscal 2005, went negative for the first time since 1983. During fiscal 2005 (ending June) nominal sales growth (with growth from acquisitions removed) was in the mid to high single digits, while food inflation was about 3.5% (nearly half), devouring (pun intended) roughly half of the Company's total revenues. So, the good news is, the offender was the benign, cyclical presence of food inflation - the volatile, dark side of inflation that systematically gets removed (along with energy) from core inflationary figures so economists can sleep at night. Given that 2004 food inflation was just as vicious, this figure is likely to be much more controlled going forward and real sales growth should

see a recovery. We also suspect that the 2005 energy run-up depressed the Company's shares (or at least capped upside) as its energy costs increased 50% from a year earlier. Black eyes aside, Sysco continued to remain at the top of the foodservice distribution/marketing mountain (16% share of the \$200+ billion market), especially in terms of profitability, turning in a stunning ROE of 37% (the fifth consecutive year of 30+%, and almost double from 10 years ago) while increasing FCF 22% and maintaining a 15+% 5 year average FCF growth rate (and a mind boggling 40% average FCF over the last 10 years!). In addition, Sysco saw its first (of 10) redistribution centers, which are 800,000 square foot regional warehouses, go operational. Going forward, this should meaningfully whittle away at operational expenses, eventually creating healthier margins. In addition, Sysco's Business Review project has been extremely successful with an average of 15% more sales per customer. During a business review, a Sysco professional representative analyzes, for instance, a restaurant and recommendations are made to the operators. The rep. then helps design a menu and tailor fit products as well as services to fit the customer's needs. Look to see this as another meaningful driver of top line growth as Sysco enlists more of their over 400,000 clients in the program. During 2005, Sysco actively focused on improving the top and middle of the P&L statement, in the obvious hopes of maintaining mid to high single digit bottom line growth. Currently trading at 18x forward earnings, we will continue adding positions while we look for Sysco to regain form in 2006.

Varian Medical Systems **A**

Varian Medical Systems is a new holding for us. Varian Medical Systems outstanding performance in the second half of 2005 earns the Company an A for the year. Varian, a very innovative Company, is the world's largest supplier of radiotherapy systems for treating cancer with a 60% worldwide market share. Varian receives 53% of their revenues from North America and 47% from the rest of the world. Varian's three business segments include oncology systems (84% of revenues); X-ray products (13% of revenues) and other which includes Brachytherapy products and the Ginzton technology center (3% of revenues). Oncology products include external beam radiation systems, software and systems for treatment planning and patient information management. Varian offers the broadest selection of x-ray tubes designed for the most advanced CT scanning radiographic, mammography and other diagnostic applications. Emerging businesses in flat panel e-ray and image detectors are helping the worldwide fight against terrorism. In 2005, Varian Medical Systems developed an X-ray linear accelerator that alerts cargo screening personnel within seconds of suspicious materials that are commonly found in explosives and weapons of mass destruction including nuclear materials.

Spurred by 2005 operating results, the stock returned over 27% in the last three months of 2005 and 16% for the year. Our initial purchases took place in July. Since then, new orders rose 14% to \$1.6 billion, their year end backlog rose 21% to \$1.2 billion, revenues increased 12% to \$1.4 billion, operating earnings rose 19%, net earnings rose 23% and earnings per diluted share rose 27% to \$1.50. We anticipate 2006 results to be similar given the under penetrated worldwide market for their superior oncology products and the unfortunate rising trend in the new incidence of cancer cases. In the world of cancer treatment (however difficult it is to state statistics here), the numbers of those afflicted grossly outweigh the per capita availability of effective therapies with about 12 cancer therapy machines per million people in the U.S. Unfortunately, it is estimated that there are 10 million new cancer cases diagnosed annually, including over 1.4 million new cases diagnosed each year in the United States. The World Health Organization estimates a 50% rise in cancer patients by 2020. In North America, there are about 13 radiotherapy units per million people which is considered to be the appropriate number given cancer rates there. In Western Europe, the number of units needed are estimated at 6.7 per million, but the supply is only 4.7 per million. Worldwide under penetration is exemplified in Asia, given the huge population, there are currently less than 1000 radiotherapy machines in use. Asia is short by 10,000 units given the recommended ratio of 4 machines per million people. International order growth has ranged from 20% to 30% the past a mere \$2 billion mark set four years and looks to continue for a long period given the lack of radiation therapy equipment. Varian controls about 70% of the worldwide market. Although a mere \$2 billion, this market is growing at a 15 to 20% annual rate. Given Varian's commanding market share, proprietary and, more importantly, effective technology (which also makes it easy for Medicare to reimburse users) they should continue to exhibit double digit growth rates into the foreseeable future. What differentiates Varian's products from their competitors is their cutting edge technology in the radiotherapy area for cancer. We all know someone who has or will go through radiation treatments in the course of trying to eradicate tumors. Each treatment has to be as individual as the patient. These cancer cases usually require treatment with some combination of: surgery, radiation and chemotherapy (currently, in the U.S., roughly 50% of all cancer patients receive radiation sometime during the course of their treatment). As a result, there is an ever increasing demand for more effective (focusing on execution) and affordable (focusing on efficiency) solutions. In the field of radiation therapy, Varian has clearly emerged as the leader in new, innovative, effective and efficient technologies. Light years (it seems) after the first linear accelerators began aggressive radiation therapy, Varian has mastered the most precise forms of therapy available, Intensity Modulated Radio Therapy (IMRT) and Image Guided Radio Therapy

(IGRT). The latest technology Varian offers is Image-Guided Radiation Therapy equipped systems. Fully loaded, the IGRT system sells for \$3 million dollars. At the end of 2005, 110 units were in deployment with 275 units on order. IGRT benefits patients by reducing the number of radiation treatments needed. One to eight high dose exposures are typically used to kill tumors, compared to the more traditional daily treatments which last over a 4-6 week time frame. As a result, patients have fewer side effects. This is accomplished by highly precise radiation treatments that account for the continuously changing shape size and position of a tumor both during a daily treatment session and throughout the prescribed course of treatment thereby sparing healthy tissue. It can adjust for shifts of up to one inch that take place when patients breathe in and out during treatment. How do you measure precision? Oncologists roughly measure precision by conformality, or the ability of a radiation dose to focus on cancerous tissue and avoid healthy tissue. If 100% of the radiation dose could be focused on the cancer and 0% on healthy tissue, there would be a 100% cure rate. Considering that tumors are often three dimensional, IMRT technology forms the radiation beam depending upon the size and shape of the tumor and the intensity is adjusted accordingly, effectively reducing the dosing field to more closely align to the shape of the tumor. IGRT takes this a step further and is able to position the beam exactly where the tumor is and calibrates on the fly, as opposed to IMRT treatments that would not always correctly position the beam because of anatomy changes (i.e. breathing or a slight movement of the targeted area). As far as efficiency goes, IMRT and, more importantly, IGRT machines are completely automated, greatly reducing the probability of human error. Previously, 30 to 45 minutes would be the normal prep time for radio therapy. IGRT decreases prep time to less than five minutes! IG/IMRT's are fast, effective and user friendly when, traditionally, radio machines were none of those. We look for continued innovation from Varian. Varian spends nearly 3 times more on research and development than their nearest competitor. Per their website, www.varian.com, for 40 years, their Ginzton technology center has been responsible for many of the innovations that have contributed to what is now known as Silicon Valley. These include pioneering work on medical imaging using ultrasound and X-ray computed tomography (CT), Nobel Prize work in magnetic resonance imaging, and other enabling work on heterojunction lasers, night vision devices, semiconductor processing technology, solar cells, and microwave integrated circuits. ROE for 2005 was 32.45%. Varian is very profitable, having produced \$160 million in cash from operations on \$996 million in revenue through the first nine months of fiscal 2005. Varian has little debt and \$400 million in cash and equivalents on their balance sheet. This month Varian will complete the purchase of 1.5 million shares which remain in an existing 6 million share buyback program. In addition, the Company

approved an additional six million shares to be repurchased in 2006. The Company currently trades at 30x's 2006 EPS estimates of \$1.79.