

**2006 STOCK SELECTION REPORT CARD**  
**THE GOOD, THE BAD AND THE UGLY**

Stock	Grade	Date Of Initial Buy	Comments
Amgen	F	3/93	<p>Amgen was our best performer in 2005. It was our worst in 2006. The stock was plagued by potential competitive threats to Amgen's blockbuster \$7 billion EPO franchise via a potential launch of Roche's Mircera (CERA) in 2007, possible generic versions of Neopogen and Epogen appearing in Europe in late 2007 and continued Medicare reimbursement issues. Amgen's stock price was punished mercilessly throughout 2006. Down 13.6% for the year - underperforming the biotech industry on a whole by 25%. Yet, Amgen continues to deliver and execute on all fronts. Revenues grew 14% - topping out over \$14 billion. Gross margins of 85% and net margins of 32% were characteristically terrific. EPS grew 19%. Free cash flow rose to over \$4 billion - or a remarkably robust 32% of sales. Focusing on their future growth and robust pipeline, expenses related to R&amp;D continue to grow as R&amp;D currently consumes 21% of sales - up 49% from 2005 levels and \$1.37 billion more than biotech powerhouse Genentech. Increased R&amp;D expenditures will support ongoing late stage clinical trials for potential blockbuster Denosumab in the areas of osteoporosis, oncology, metabolic disorders and rheumatoid arthritis, as well as for phase III studies of newly approved Vectibix in front-line colorectal cancer, phase III studies for AMG 531 (a treatment for chemotherapy-induced thrombocytopenia; which affects almost every patient undergoing cancer treatment) and phase II studies for AMG 706 which is designed to inhibit growth of blood vessels required for tumor formation and metastasis. Amgen's sales of their dominant EPO franchise (Epogen/Aranesp) (which produces close to one-half of overall product sales) may be reduced if the FDA approves Roche's CERA for the treatment of chronic kidney disease (CKD) in patients receiving dialysis treatment. A decision is expected in or before May 2007. Amgen has filed a patent litigation suit against Roche which will go to trial in September 2007. A preliminary injunction is expected to be filed by Amgen to keep CERA off the market if it is approved pending the outcome of the September trial. A favorable outcome could permanently prevent Roche from launching CERA in the U.S. The market has more than abundantly priced in what we believe would result in slim market share erosion</p>

from a CERA launch. *The Wall Street Journal* (2/26), reported that Roche suspended their trial enrollment for anemia drug CERA due to safety concerns. The suspension comes because of an "imbalance" of deaths across the four arms of the study in anemic lung cancer patients. This could be a potential boon for Amgen because this might make it less likely that CERA will be approved by the Food and Drug Administration. The generic threat may be overblown as well as Amgen is currently switching patients from Neupogen to newer, more effective Neulasta and from Epogen to Aranesp. Also, the high costs of patient trials and extremely expensive biologic manufacturing expenses will indubitably limit the returns to generic competitors ensuring a small number of competitors. Amgen is decidedly deserving of a higher valuation given that it is currently trading at a historically low multiple of 16X 2007 EPS consensus estimates of \$4.41 - which is a discount to the biotech groups median P/E in the mid-20's. Given Amgen's robust product pipeline and steady cash flow generation along with an extremely aggressive share buyback program, we feel patient investors will be rewarded. As a result of the recent (April and May) negative headlines surrounding the company's EPO franchise, Amgen's stock price has plummeted to a low not seen since October 2004. This current quagmire is the outcome of conflicting study results of off-label usage, draconian restrictions proposed by the CMS, and the prospect of a U.S. launch of Roche's Micera. We believe Amgen has been oversold, presenting a very favorable risk/reward scenario. Just as management has upped their open market purchases of the stock, we remain buyers of this leading biotechnology behemoth as we believe there are positive factors discounted by the market. (1) The drugs under scrutiny have a twenty year history of safety and of improving patient's quality of life when prescribed according to FDA recommendations. (2) Recent CMS proposals are not based on sound scientific rationale. In fact, this is the second go-around as the CMS tried to change the reimbursement policy for Epogen in dialysis patients in 1997. Their proposals were met with such public and medical community outcry that the implemented proposals were reversed within three months. (3) FDA approval and the subsequent U.S. launch of Roche's Mircera is surely at risk with the continued analysis and negative headlines thrust upon Amgen's EPO franchise. (4) Amgen is currently trading at 13x 2008 EPS estimates, a far cry from the historical and warranted 18x we believe the stock is worth. (5) Having confidence to navigate these unfriendly waters, confidence in their long-term prospects and possessing an enviable pipeline, management has indicated their intent to raise their share repurchases from \$5 billion to \$6.2 billion.

On May 10<sup>th</sup>, the Oncologic Drugs Advisory Committee

(ODAC) met to evaluate the usage of Amgen's Aranesp and Epogen and Johnson and Johnson's Procrit. Epogen was introduced in 1989 to treat anemia associated with chronic renal failure in patients both on dialysis and not on dialysis and it was named "Product of the Year" in 1989 by Fortune magazine. Currently, Epogen captures greater than 85% of the U.S. dialysis market. Aranesp was introduced in 2001 and is used to not only treat patients with anemia associated with chronic renal failure, but also for the treatment of chemotherapy-related anemia. Forty-nine percent of cancer patients have anemia as a side effect of chemotherapy with about 55% of these receiving treatment. Procrit (Epogen) is sold by Johnson and Johnson through a licensing agreement with Amgen. These drugs (proteins) are created from the genetic engineering of living cells and they are erythropoiesis-stimulating agents (ESA's) which work by stimulating the bone marrow to produce more red blood cells. They reduce fatigue and allow patients to breathe easier and eliminate the need for blood transfusions thereby vastly improving the quality of a patient's life. (Patients can walk and talk at the same time.) Through twenty years of usage and over 50 studies, ESA's have been shown to be safe when used according to their FDA approved label of achieving hemoglobin levels of 10-12 grams per deciliter of blood. But, recent studies conducted by Amgen and independent physician groups have shown that ESA's increase the risk of heart attacks, stroke, blood clots and death when hemoglobin levels reached off-label levels of 13g/dl. or higher. In addition, in an effort to broaden the use of Aranesp, Amgen sponsored a study to treat patients with anemia caused by cancer itself but not receiving chemotherapy and the results of this study backfired as these patients received just as many transfusions and died more often as those treated with a placebo. As a result of these studies, the FDA slapped a black box warning on off-label usage to warn physicians about the potential risks noted above. The FDA specifically noted head and neck cancer in combination with radiation, use in metastatic breast cancer to hemoglobin levels greater than 12 g/dl. and in cancer patients anemic due to their underlying disease. On a positive note, Amgen's recently announced results of their "145 study" which indicated that in 600 previously untreated patients with extensive-stage small-cell lung cancer who were receiving chemotherapy, there was not a statistically significant difference in death. In response to conflicting study results and increased awareness of maintaining appropriate dosage and hemoglobin levels, the FDA's ODAC panel recommended that additional warnings be added to the labels of Epogen, Aranesp and Procrit. The panel voted as follows: (1) They voted 15 to 2 in favor that the FDA narrow the indication for chemotherapy-induced anemia, but did not make specific recommendations on what the label

restrictions should be. (2) They voted 12 to 5 that the FDA should modify the labels to include safety signals for specific types of cancer, but did not mention any specific cancer types. (3) They voted 15 to 2 that a specific hemoglobin level should be defined at which treatment should be initiated, but did not specify at which level. (4) They voted 11 to 6 against lowering the upper limit of hemoglobin levels from the current 12 g/dl. level. (5) They voted 16 to 1 that the labels should be modified to discontinue therapy once chemotherapy is stopped. In addition, the panel issued recommendations involving additional trials in the on-label settings and disease-specific restrictions, which were vague and could have a negative impact on Amgen's revenues. Amgen, already committed to cutting expenses to offset declining sales of their EPO drugs, faces increased costs of conducting these additional FDA recommended clinical trials. Aranesp, Amgen's most successful drug, grew at a 26% YOY growth rate in 2006 and when combined with Epogen, produced revenues of \$6.6 billion totaling 46% of Amgen's total sales. (61% nephrology, 39% oncology) Another FDA panel meeting is scheduled for later this year to discuss the risks of the anemia drugs in patients with kidney failure. In response to the above underlined points regarding the final FDA recommendations, growth projections for the EPO franchise have been reduced. In a surprise announcement, on Monday, May 14<sup>th</sup>, four days after the ODAC meeting, Medicare proposed Aranesp reimbursement restrictions in cancer that went beyond the proposals of the ODAC panel, specifically: No initiation above a Hb of 9, 12 week max duration, No use with Avastin, and New rules around withholding doses in rapid or non-responders. Remember; these restrictions are not final; they are open to 30 days of public comment and then 60 days to implementation based upon final decisions. The stock has dropped an additional five percent after the announcement. The FDA's Cardiorenal Advisory Committee in the fall will further vote to restrict usage of Epogen in the nephrology setting representing approximately 18% of Amgen's total sales. Thus, there may be further weakness in the stock until CMS and FDA complete their review of the product labels and reimbursement in the nephrology setting. Amgen shares may decline further if U.S. regulators were to approve a rival anemia drug from Roche AG. U.S. regulators are expected to act later this month on Roche's Mircera, which is in the same class as Amgen's EPO franchise. We do not expect this, since we believe with all the scrutiny and uncertainty brought to the fore, that the FDA will require further testing of Roche's drug. Although Aranesp represents 28.9% of Amgen's product sales, 19.7% of these sales are in the U.S. A further breakdown reveals that 14.8% of U.S. sales are in the cancer setting. Of this 14.8%, only 2.8% is off-label usage. With the inclusions of reductions in head and neck cancers and reductions in

nephrology usage, we look for a total reduction in 2008 revenues of approximately 4.5% of total sales and \$0.54 per share. While the FDA recommendations and Medicare proposed restrictions sound dire and unmanageable, (politically motivated?), we believe Amgen has been oversold (down 23% for the year) and that most physicians will continue to prescribe EPO drugs at FDA recommended on-label targets of less than 12g/dl. In addition, we believe the FDA will not make changes to the black-box warning as study after study has shown these drugs to be safe over a twenty year period at prescribed levels. The risk of depleting the nation's blood supply also will be taken into consideration by the FDA when evaluating changes to current prescribed levels. The company announced they will draw down under a commercial paper program to repurchase stock. Despite the decline in Epogen & Aranesp sales, the firm expects 8-11% YOY EPS growth in 2007-09 due to expense control and share repurchases. Amgen shares are cheap trading at 13X 2007 EPS (incl. ESA reductions) & PEG of 1.5 based on 3-year EPS CAGR of 9% and a cash flow yield of over 7%. The PE & PEG of drug stocks are 17X & 2.3, respectfully. With a market implied growth rate of -4.6% which is based on these short term overhangs, we believe the company is worthy of a much richer valuation given its tremendous pipeline and oversold condition. Putting a conservative 15 multiple on the stock's reduced 2008 estimates yields a target price of \$68.00—back to where it started the year.

**Apple Computer**      **B+**      **10/05**

In 2006, Apple (the stock) offered thrill seekers such as those frequenting Disney World or Six Flags (13-year olds who drag their parents on every ride) a new option. Talk about frightening rides (move over Manhattan Express), Apple was down 19% in the first half of 2006 closing at \$57 on June 30<sup>th</sup>. Oh, but what a joyride the second half turned out to be as the stock rallied 48% closing at \$84.84 on December 30<sup>th</sup> to end the year up 18%! Even though our portfolios lagged the major indexes all year due to *stocks* like Apple, we are glad we were on that thrill ride. *Companies* like Apple are few and far between. Definer of industry dynamics, Apple has capitalized on their technological capabilities and uncanny foresight creating products that can be fully utilized and enjoyed by those lacking in any miniscule amount of technological competence. (Speaking from personal experience while I type away on my MacBookPro.) This is from the company's December 2006 10-Q: *"The Company believes that for both professionals and consumers the personal computer has become the center of an evolving digital lifestyle by integrating and enhancing the utility of advanced digital devices such as the Company's iPods, digital video and still cameras, televisions, CD and DVD players, mobile phones, and other consumer electronic*

*devices, including the Company's iPhone that is expected to begin shipping in June 2007. The attributes of the personal computer that enable this functionality include a high-quality user interface, easy access to relatively inexpensive data storage, the ability to run complex applications, and the ability to connect easily to a wide variety of other digital devices and to the Internet. The Company is the only participant in the personal computer industry that controls the design and development of the entire personal computer.....from the hardware and operating system to sophisticated applications. This, along with its products' innovative industrial designs, intuitive ease-of-use, built-in graphics, multimedia and networking capabilities, uniquely positions the Company to offer innovative integrated digital lifestyle solutions. The Company's business strategy leverages its ability, through the design and development of its own operating system, hardware and many software applications and technologies to bring to its customers around the world compelling new products and solutions with superior ease of use, seamless integration, and innovative industrial design."*

What are the results of Apple's efforts? Revenues have grown nearly exponentially from \$5.7 billion in 2002 to just under \$21 billion in 2006. Return on shareholder equity catapulted from 1.6% to 24.7%. Net margins increased from 1.1% to over 10%. Have shareholders been rewarded? You bet! Apple returned 49% in 2003, 204% in 2004, and 123% in 2005 as Steve Jobs and his brain trust worked their magic. But the ultimate question is, "Can Apple continue to innovate and escalate their market share take in present markets as well as with new endeavors?" We obviously believe they will as 2007 promises to be loaded with new product introductions to drive future revenue growth. More on that later. But now, a recap on Apple's excellent financial results for their latest quarter: First quarter 2007 results were driven by new product introductions and product updates that occurred in 2006. (All of the following results are in comparison to first quarter 2006.) Apple Q1-2007 results ended December 30, 2006 and Apple reported record quarterly revenue of \$7.1 billion and record net sales of \$1.4 billion – an increase of 24%. Diluted earnings per share grew to \$1.14 vs. \$0.65 - much higher than analysts expectations of \$6.4 billion and \$0.78 per diluted share. Gross margin expanded to 31.2% vs. 27.2% due to lower commodity prices and a better product mix. Apple successfully transitioned to using Intel Dual Core 2 chipsets in 2006. Macintosh sales increased 40% in the latest quarter as portable products increased 79% as well as a shift in the mix of desktop sales from the iMac and Mac mini to the iMac. Fifty percent of those buying Mac's are new to Mac. The halo effect is alive and well at Apple - allowing Apple to grow sales faster than the industry as a whole. According to Net Applications, the Mac product line has grown to own a 6.2% market share in January 2007 up from 4.3% in August 2006. Also in 2006, Apple Boot

Camp was introduced and it allows users with a Microsoft Windows XP installation disc to install Windows XP on an Intel-based Mac. Once installation is complete, users can restart their computer to run either Mac OS X or Windows XP. Boot Camp will be a feature in "Leopard," Apple's next major release of Mac OS X. Since the introduction of Boot Camp, downloads of the Microsoft operating system exceeded 1.5 million. Maybe Steve Jobs gets the last laugh after all now that purchasers of an Apple Mac computer have the option of running two, three or more operating systems concurrently. Who could have imagined that Microsoft Vista, Mac OS X and Linux could run side by side? Could this introduce another revenue line as Mac moves beyond core competencies in the consumer, creative and education markets infiltrate the Enterprise arena? Game. Set. Match. The Mac product line is offered in more than 7,500 outlets worldwide. Reasons cited for the increase in Mac' market share include: superior security vs. Windows, Apple's growing retail store base, the iPod halo effect, award-winning design, Mac OS X, Mac-only applications such as iLife, ease of use, the Mac's ability to run Mac OS X, Linux and Windows concurrently, word of mouth and excellent reviews (whew!) Sales of the iPod line (traditional iPods, Nano's, iPod video, and Shuffle's) increased 18% - as unit sales totaled 21 million vs. 14 million in the first quarter of 2007. Over 90 million (now through 40,000 outlets) iPods have been sold since their introduction in 2003. An update to the iPod product family occurred in September 2006 and Apple holds a commanding 72% of MP3 sales in the U.S. Sales of music related products and services increased 29% as there was significant growth in the U.S., Europe and an expansion of audio and video contents via the iTunes store. Currently, the Apple iTunes music store accounts for 62% of all music download sales on the web and it offers over 4 million songs, 350 TV shows and 250 movies. Music and services compose 57% of Apple revenues. The Apple retail initiative with 170 stores has proved to be a boon to the company as Apple stores lead all other retailers with annual sales of over **\$4000** per square foot per year. (Yes, even higher than Tiffany's (\$2,666 per sq. ft.) or Neiman Markus (\$611 per sq. ft.)). Brand awareness is increased with their retail stores enhancing the "halo" effect and Apple is able to capture the retail markup on their products that would be pocketed by resellers otherwise. Stores are an average of 6000 square feet; which bring in more than \$23 million in annual sales each which contribute to over \$200 million in operating profit per year. The company ended the year in pristine financial shape with over \$12 billion in cash and marketable securities on their balance sheet. Net of \$13 cash per share. The introduction of the revolutionary iPhone is just around the corner. Don't be surprised if the iPhone (similar to the IBM PC in 1983) is named *Time* magazines "machine" of the year.

Berkshire Hathaway	A	12/98	<p>We have owned Berkshire Hathaway continuously since 1998. After a flat 2005, these shares gained 25% in 2006. (A painful aside: We have intimately known the Berkshire Hathaway “story” since we began our investment careers in the mid-1980’s. It goes without saying that our likely single biggest error of our investment career has not been owning these shares ever since then.) The most common question we continue to get asked in one form or another, is; “Why does a ‘growth’ manager like Wedgewood own a ‘value’ stock like Berkshire?” So common was this question that we penned a Client Letter (<b>Wedgewood View</b>, 1<sup>st</sup> Quarter 2004) entitled: <i>The Greatest Growth Company Wall Street Never Heard of: Berkshire Hathaway</i>. Warren Buffett’s reputation as arguably the greatest ‘value’ investor ever certainly precedes and influences such a question. Yet, we continuously state to our clients that Buffett’s growing reputation as one of the greatest <i>businessmen</i> ever may ultimately eclipse his reputation as an investor. So, how did this ‘growth’ company we speak so highly of do in 2006? Well, glad you asked. How does a gain of 18.4% in net worth sound? How does a 38% increase in non-insurance earnings sound? How about a non-insurance ROE (largely unlevered) of 25% sound? How about an 11-year pre-tax earnings growth rate of 31.7%? How about \$57 billion in extraordinary low-cost float? How about an underwriting profit of \$3.8 billion? How about an 11-year per-share investments growth rate of 12.6%? Maybe we should let Buffett describe Berkshire’s outstanding 2006 growth with his own words: <b>“We believe that \$16.9 billion is a record for a one-year gain in net worth – more than has ever been booked by any American business...”</b> In our 2005 Report Card we stated that the shares of Berkshire were so cheap that it would most likely our best performer in 2006. It was. Remarkably, we believe that the stock today is cheaper than it was at the end of 2005. We believe minimum fair value of Berkshire Hathaway (B shares) based on capitalizing pre-tax earnings at a multiple of 16X is \$4,600. We believe the upper end of fair value based on capitalizing non-investment, pre-tax operating earnings at a multiple of 12X is \$5,300. These shares have been one of our largest holdings ever since we have owned them – usually our single largest holding. Berkshire Hathaway is currently our largest holding. We expect this to be the case for years to come.</p>
Commerce Bancshares	C-	8/04	<p>The stock was essentially flat for the year after a decent 2005. Dubbed “America’s Most Convenient Bank” with more than 400 “retail” locations open seven days a week, Commerce Bancorp has been able to grow assets, loans and deposits by 36%, 28% and 36%, respectively over the last five years. Total revenues, net income and earnings per share have increased 28%, 29% and 21% over this</p>

same period of time. Commerce has a long history of growing deposits at a multiple of their peers. 2006 was no exception. In 2006, core deposits (exclude government deposits) grew 18% to \$6.2 billion. Core deposit growth per store was an industry leading \$17 million. Commerce continues to be a deposit gathering juggernaut. Total deposits grew \$6.6 billion, up 19%. New York City's 57 stores led growth in deposits - growing 43% year-over-year on average, or \$39 million per store. Net income of \$315 million was up 11% and earnings per share remained flat due to the effects of the margin-reducing inverted yield curve. Commerce opened 55 stores in 2006 as they march toward their stated goal of 800 stores and \$100 billion in assets by 2010. The average Commerce store has collected \$120 million in deposits and is gathering new deposits at a pace of an average \$18 million per store per year. By comparison, it takes branches of other banks about *ten* years on average to accumulate \$50 million worth of deposits. Given Commerce's long history of rapid deposit growth, the company's business model is unusually interest rate sensitive due to Commerce's inability (re: refusal) to make loans as fast as deposits are coming in - an "advantage" other banks do not have due to slower deposit growth. However, interest rate risk is partially mitigated with these large deposits, as these deposits act as an interest rate hedge as the majority of deposits are invested in shorter-duration, AAA-rated securities. Traditionally, Commerce has exhibited a better credit profile with a low level of high risk loans and a history of better than average credit quality - which may be a positive catalyst in a decelerating economy. Commerce has been hit hard due to the current rare interest rate environment in which long term rates have the same or lesser level of yield as short term rates. This flat/inverted yield curve has affected banks on a nationwide basis and has resulted in a reduction in Commerce's net interest margin (NIM), which reached an all-time low of 3.25% in the 4<sup>th</sup> quarter (27 bps. below 4Q05 and 98 bps. below 4Q04). Specifically, net interest margin represents the difference between interest income and interest expense and is reflected as a percentage of average interest earning assets. Commerce projected their NIM to be in the range of 3.25% plus or minus 5 basis points in the first half of 2007 and they do not expect to see any meaningful increase in their NIM until the yield curve slopes positively. This usually occurs when the Fed begins to cut rates. Again, in a decelerating economy, Commerce would exhibit positive leverage to Fed interest rate cuts. As a result of this difficult interest rate environment, which is pressuring earnings, Commerce has revised their growth targets downward and noted that controlling expenses in 2007 will be a focus - although they still plan on opening 65 branches in the upcoming year. Expected revenue growth rates were lowered to 20% from 23%-25%, comparable store deposits lowered to 15%-20% vs. 18%-20%, core deposits to 20% from 24%-26% and EPS to

15%-18% from 18%-20%. Bottom line: What's the thesis on Commerce given their downward revised growth projections? We believe that the most negative scenario is playing out (inverted yield curve) as we speak, but given a worsening housing market, consumers spent up, and a declining corporate profit picture, something has to give. But these negative cyclical conditions take more than a few quarters to play out and we expect the Fed to start easing by the second half of 2007. We see significant opportunity in Commerce at current prices as their NIM becomes more normalized. The stock is currently trading at 17.6X's 2007 depressed EPS estimates of \$1.80 (138% premium to group vs. historical relative P/E of 142%). With the unleashing of a more normalized NIM (4Q05 level of 3.5%), EPS expands \$0.30-\$0.35, which means the stock is currently trading at 15X's \$2.10, which is a premium of only 115%. Given Commerce's inherent leverage imbedded in their asset structure, Commerce can grow earnings at a much greater rate than a traditional bank in a more normal interest rate environment, therefore, it deserves to trade near or above the historical range of 142% to its peer group which would imply a multiple of 18.5X and a stock price of \$39. Interestingly, the return on equity of Commerce's banks that are 6 years old and older is 17.6%. Fifty-seven percent of their banks are less than six years old. As these 228 banks mature, we look for earnings to pace increases on maturing stores. Significantly, the stock is currently trading at just a 10% core deposit premium (market value less tangible equity as a percent of core deposits), which is a historical low for the company and below the 13% premium that the stock bottomed at in 2004 after the indictments of two Philadelphia Commerce executives. Recent bank acquisitions have been done at 25%-30% premiums. Like it or hate it (we love it), Commerce is one controversial story. Most Wall Streeters and bank industry executives guffaw at Commerce's "retail" attitude. Study after study shows that banks with the highest deposit growth rates (particularly organic deposit growth rates) are the best long term bank stock performers. We expect the stock price to be pressured in the short term due to concern that Commerce has been advised that an investigation by the Officer of the Comptroller of the Currency in conjunction with the BOD of Federal Reserve System is currently underway. The scope of the investigation included but is not limited to transactions with its officers, directors, and related parties, including transactions involving bank premises. The company noted that this is a regulatory matter and they would not be able to answer questions pertaining to the subject at this time. At current valuations we are eager buyers of this stock.

**Gentex**

**F**

**12/97**

After receiving an A in 2005, Gentex disappointed with an alarming 26% price decline in the first five months of 2006

resulting in expulsion from our portfolios. Gentex, a fixture in our portfolios since 1997, finally succumbed to U.S. automakers dire economics with a 2.5% price concession on their popular auto dimming mirror - which resulted in a sharp 295 basis point decline in gross margin in the first quarter of 2006. At first blush deceiving, Gentex reported revenue growth of 9% and earnings in-line with expectations in the first quarter. Further scrutiny revealed a lower quality of earnings as their revenue number was enhanced via a 70% jump in other income due to higher interest income and sales of investments. Cash flow from operations declined 10% in the quarter as the company became less profitable. A light at the end of the tunnel? Nope. With slower economic growth and a weak housing market, U.S. vehicle sales are expected to hit a 9-year low in 2007 with sales of just 16.4 million vehicles. (We exchanged shares of Gentex for Yahoo.)

Home Depot D 5/95

We have owned Home Depot for some time (May of 95). No doubt the company has had an extraordinary track record, compounding at 20% growth over the past 10 years. Any type of sustained, double digit, teens growth rate is difficult, at best, (please see Wedgewood's 2Q 2005 client letter, available on our website), but 20% growth over an entire decade is, again, a rarity. To put that type of growth in perspective, Home Depot is the only current Dow component that can boast 20% growth during that period (Microsoft comes in second with 18%). Given the fundamental underpinnings of equity markets, as a company grows (especially at that clip), so grows its stock price -- and of course, visa-versa. During 2006, it became more evident that the company was facing unprecedented (given Home Depot's history and their current market presence) macroeconomic headwinds that represented a serious threat to their double-digit growth tenure. As a disclaimer, rarely do we consider ourselves top-down, macro-oriented investors, but given the contraction in housing we believe a long-term contraction in the Do-It-Yourself market is imminent. Our thesis for the health of the housing market and its potential effects is detailed in our first quarter Client Letter. Saturation of target markets dramatically increased due to the rapidly shrinking housing-induced subsidy that all DIY retailers enjoyed during the past 5 years. The company was forced to recognize this and opened their fewest stores (86) in half a decade - bringing their total worldwide store count to around 2,100. Compounding that, the 2006 fiscal year presented the company with negative company-specific events such as: management's speculation into the selling Home Depot Supply. Our thesis for the company's future growth has relied on this business, which thrives by catering to the professional/contractor market. Given the company's starting point in this market, was near zero, we think the selling-off of their supply business unit represents

a passed over opportunity, and signals that management is hardly on the same page as its shareholders, let alone its own game plan (in early 2006, they targeted HD Supply to be 20% of revenues by 2010). In addition, the six-sigma style of management (instilled by ex-CEO Bob Nardelli), we believe, has detracted from the stores consumer appeal, given the rise of Lowes and their consumer-oriented store model. Lack of shareholder oriented behavior, management's turmoil and departure from stated long-term game plans, as well as the looming macro-storm, led us to part ways with HD in early 2007.

**Legg Mason**    **F**        **9/02**

2006 was a most difficult year for Legg Mason. We noted in last year's Report Card that the company's plate would be full in 2007 digesting their acquisition of Citigroup's asset management division. Little did we forecast that the company would nearly choke on it. Suffice it to say that while the myriad of integration issues took longer to complete than we (or the company) expected, the integration is largely complete. The stock has been duly (and at times; unduly) punished. Yet at current valuations these shares trade at a discount to like firms. We expect 2007 to be a year of renewed organic growth, better profitability and a renewed awareness at the depth and breath of the "new" Legg Mason.

**Linear Technology**    **F**        **5/96**

Linear Technology shareholders have suffered through another poor year. The stock was down -6% in 2005. It was down -16% last year. We have written extensively on the company's amazing business model every year in past Report Cards. The company has navigated through a cyclical inventory correction with market share intact. The firm still has doubters that the company's operating philosophy of "margin first" rather than "revenue first" is the right course. We are staying the course with management. The company has never had an unprofitable year as a 20 year-old public company. The company has posted **82** consecutive quarters of positive cash flow from operations – an astonishing accomplishment for any company, much less a technology company...much less a semiconductor company. Management's frustration over the languishing (and cheap) stock, plus their conviction of the company's future business opportunities has led to a leveraged repurchase of a third of the outstanding shares.

**Medtronic**        **D**        **1/05**

Although Medtronic was down 7% for the year, we remain buyers of the stock as Medtronic's strength lies in the fact that they operate in a number of different markets, most of which are highly under penetrated. No longer a pure-play medical device company, they are a medical technology company. Much of Medtronic's R&D focuses on information technologies, biomedical engineering and

semiconductor technologies as they manufacture and produce the integrated circuits that run most of their devices. With over 14,000 patents to its name, 80% of Medtronic's growth in the last 10 years can be attributed to new product introductions and expansion of therapies for new patient groups. In the last 12 months, Medtronic has added 750 research, clinical and technical personnel to support their robust pipeline. They operate in over 120 countries and have over 36,000 employees. Medtronic is well positioned with leading market share in the fastest-growing segments of the medical device space including spine, diabetes and neuromodulation. The company possesses a strong line-up of new products in 2007. Clinical progress is being made on new indications for neurostimulation therapy. A pivotal trial data supporting reimbursement for continuous glucose monitoring is underway and key artificial lumbar and cervical disc launches are scheduled for 2007. Medtronic spends 10% of revenues (\$1.1 billion) on R&D and currently has over 200 clinical trials under way. 2006 return on equity has escalated to 28. Medtronic has succumbed to an unexpected decline in its largest business (25% of revenues) after they reported that sales of Implantable Cardiac Defibrillators (ICD'S) grew -6% in their fiscal 1Q07 after delivering a 23% gain in fiscal year 2006 (April fiscal). Most of the blame is attributed to ICD product defects which affected all three major CRM device manufacturers ( Medtronic, Guidant and St. Jude Medical). (A defibrillator is a medical device that uses an electric shock in order to re-establish normal heart rhythm.) Medtronic issued a press release in February 2006 voluntarily advising physicians about a potential battery shorting mechanism that could occur in a subset of implantable cardioverter-defibrillator (ICD) and cardiac resynchronization therapy defibrillator (CRT-D) models. In a letter to physicians, Medtronic reported that nine batteries (0.01 percent or approximately 1 in 10,000) have experienced rapid battery depletion due to this shorting action. If shorting occurs, battery depletion can take place within a few hours to a few days, after which there is loss of device function. There were no reported patient injuries or deaths, although the company is facing the possibility of hundreds of personal injury lawsuits due to a recent U.S. District court decision denying Medtronic's motion for summary judgment. The company is expected to appeal the decision. In their fiscal 2Q07 Medtronic reported that ICD sales dramatically rebounded, growing double digits sequentially allowing the company to increase their worldwide market share to 56%, up from 52%. The ICD market is under penetrated with an estimated 1.3 million people in the U.S. indicated for ICD usage, but only about 32% have received the device. Medtronic's efforts to stimulate growth in the market include expanding their field force to call on cardiologists and electro-physiologists directly to inform them of the benefits of ICD's in order to tap into the 70% of eligible patient population. They are

also embarking on The Sudden Cardiac Arrest national awareness campaign that began in mid-January which is aimed at physicians, patients and hospital administrators in order to improve the awareness of both the risk and prevalence of sudden cardiac arrest together with the effectiveness of ICD therapy. Worldwide, ICD sales are expected to rebound and increase 8.9% in 2007 and 9.2% in 2008 as overseas markets are growing fast, particularly Southeast Asia. From their 2006 annual report, *"Medtronic's mission is to apply biomedical engineering to alleviate pain, restore health and extend life. Today, about every 5 seconds, a Medtronic product saves or substantially improves a life somewhere in the world."* Notably, ten years ago the company was primarily a pacemaker company. Today, Medtronic offers devices/therapies in: Cardiac Rhythm Management (13% growth in 2006, \$5.2 billion), Spinal and Navigation (19% growth in 2006, \$2.2 billion), Neurological (10% growth in 2006, \$1 billion), Vascular (10% growth in 2006, \$939 million), Diabetes (10% growth in 2006, \$722 million), Ear, Nose, and Throat (9% growth in 2006, \$501 million) and cardiac surgery (-1% growth in 2006, \$663 million). The Neurological division offers help for Parkinson's disease, Hydrocephalus, obsessive-compulsive disorder, depression, spasticity, epilepsy, chronic pain and cranial and spinal surgery. The ear, nose and throat division offers help with Meniere's disease, ear infections, sinus infections and thyroid disease. The Spinal division helps those with spinal deformities, herniated disc, degenerative disc disease and acute tibial fractures. Gastroenterology helps those with acid reflux, gastroparesis, obesity and fecal incontinence. Vascular addresses patients with coronary vascular disease, peripheral disease and aortic disease. Their recently introduced Endeavor stent has been launched in over 100 countries and has taken 20% market share. A U.S. launch is expected in mid-2007. Urology address patients with overactive bladder and urinary retention, as well as those with benign prostatic hyperplasia. Diabetes division help patients with external and implantable insulin pumps, real-time continuous glucose monitoring system and therapy management software that help diabetes patients improve blood sugar control. There are over 1 million Type 1 diabetics in the U.S. alone and an estimated 3-4 million Type II diabetics. Cardiac surgery helps patients that have heart valve disease, coronary vascular disease and atrial fibrillation. Lastly, Cardiac Rhythm Disease management addresses irregular heart rates, heart failure, and unexplained syncope and offers remote device monitoring. Medtronic, trading at 21X fiscal 2007 estimates of \$2.30 is currently trading below their ten-year historical average premium to the S&P 500 Index (39% vs. 59%). We believe the company deserves a higher multiple given their well-positioned, diversified and under penetrated and growing product line.

Microsoft B+ 6/00

Much to the respite of many a longtime Microsoft holder (guilty as charged), Microsoft ended the year up 15%, after a dismal showing in the first half of 2006. The stock bottomed on June 13<sup>th</sup> at \$21.46, but rebounded 39% to end the year at \$29.83. Microsoft's stock plunge was not the result of their third quarter earnings (revenues growing 13%) as the stock was a penny shy of consensus expectations, but was due to their lowering earnings guidance for the fourth quarter as well as for fiscal 2007. Although Microsoft guided revenue growth at 14% for 2007 (with free cash flow growth of 34% stemming from the prospective release of Vista (which has 90% gross margins), Microsoft announced earnings would be less than expected because of an increase in operating expenditures in 2007 of 18% to \$23 billion, \$2.1 billion ahead of estimates. At that time, the company left investors with sketchy details (at best) in regard to when the funds would be deployed and what value would be generated by the investment of the additional \$2.1 billion. We applauded Microsoft's decision to sacrifice short-term profits for long-term growth. Not only would they protect their own turf, but they would be investing large sums to take advantage of secular trends dictated by the Internet. We believed as many did that Microsoft would use the funds not only to ramp spending in Xbox 360 marketing and to hire additional sales personnel ahead of their upcoming Vista and Office product releases, but more importantly they would use the funds to embrace and offer on-demand software (before Google or Yahoo offered large scale services for business over the web) and to counter-attack Google and Yahoo. Between August 2005 and December 2006, Microsoft's worldwide search query market share has declined from 11% to 8%, while Google increased their market share from 56% to 65%. Microsoft's U.S. market share declined five percentage points to 11 percent while Google's increased 12% to 47%. Rumors of Microsoft acquiring a stake in Yahoo (combining Microsoft's technology and Yahoo's customer base) to compete more powerfully with Google ran rabid in 2006. The buyout would have been much cheaper during October when Yahoo touched a low of \$22.65, but what's a couple of billion here or there when you have over \$30 billion in cash on your balance sheet? From *Fortune* magazine's July 2006 article on Microsoft, per Microsoft's Chief Technology Officer, Ray Ozzie, *"I am amazed at the amounts Microsoft is spending, and that the cost of building the physical infrastructure for web services will be a major barrier limiting the number of players in this business. The people who could build viable services infrastructure of scale are companies that have both the will and the capacity to invest staggering amounts of money-staggering amounts. Think billions, many billions."* Microsoft has \$36 billion in cash on their balance sheet. They have the scale to become a serious contender. The industry is still young with plenty of room for growth and

there is enough room for 2-3 players in this industry. In 2000, only five million Americans had fast Internet access and the current total is near 80 million. Individuals spend upwards of 180 hours on the Internet per year with E-commerce retail sales nearing \$90 billion and Internet advertising revenue nearing \$16 billion. But...Microsoft is still years behind other software-service providers and they will have to spend billions to catch up even though have rebranded and revamped Windows Live Search. We are patient investors....but perhaps not that patient. While earnings have grown an average of 33% annually over the past three years, their core products (Windows, Office, SQL Server) are growing nicely (9%) with SQL Server up 16% year over year and they are spending to compete effectively long-term over the Internet, we have taken our gains and exited the shares as of this writing on the heels of a surprisingly poor Vista release.

**Paychex**      **N/A**      **4/01**

We have held Paychex in the portfolio since mid-2001. We liquidated our positions in the stock during 2006 and eventually funded positions in Whole Foods Market with the proceeds. Paychex had a number of earnings drivers that relied on heavily cyclical events. Specifically, these drivers are interest rates and job growth. As we will continually state, we do not consider ourselves top-down macro investors, however the looming macro storm has moved us to neutralize the portfolio from as much cyclical exposure as possible.

**Procter & Gamble**      **A**      **8/05**

Procter & Gamble was a late addition to our portfolios in 2005. The stock posted a solid gain of 10% in 2006. The company executed well during 2006. International sales are most impressive. Their product presence is felt in over 180 countries with over half (53%) of FY 2006 sales brought in from overseas. Further, about a quarter of total sales are derived from developing markets, where PG has obviously honed its skills, evident in the double digit growth that is occurring. Much of the success in the developing world is due to: 1.) winning consumers over with spectacular in-store presence (branding, advertising) and 2.) Maintaining those customers with superior, value-added quality. As a result, PG receives an "A" for its operational *and* stock performance during 2006. Returning 13% during the year, PG outpaced the Russell 1000 Growth Benchmark by over 400 basis points. To quote PG CEO, A.G. Lafley a few years ago, "The most precious kind of growth," he said, "is organic growth—top-line expansion of your core business, without reliance on acquisitions...You want to grow your core assets, because you understand them the best...if you can't, you've got trouble." Sticking to his guns, Lafley and the rest of PG management targeted 4 to 6% long-term organic growth for the company, in the face of a 2 to 3% per annum

growth of the underlying consumer products market. Now if you recall during 2005, PG acquired the consumer products manufacturer, Gillette, thus fixating the expectations of the investment community upon the PG-G integration effort -- not exactly following the said route of "precious" organic growth. However, in his defense, Lafley bluntly stated "we don't need to (acquire Gillette)," but said the Gillette market of men's grooming was expanding faster than the overall market and would enhance organic growth going forward. So the acquisition made imminent sense. Fast forward to the end of 2006, the PG-G acquisition went off without a hitch, producing one of the most formidable consumer product juggernauts on the planet, and now the results of the PG and G operations are considered, on a GAAP basis, to be officially organic. The New PG throws its weight around in the form of a massive portfolio of consumer products consisting of 22 lines that each report \$1 billion in sales, with another 16 lines that report at least \$500 million in sales each. As a result, PG doesn't necessarily witness any sort of direct competition on a company-basis, rather multiple companies end up competing with PG's multiple products. In order to maintain the necessary brand-upkeep for the dozens of products that PG carries, the Company operates a highly clandestine retail innovation center, complete with a fake retail store, a fake coffee shop and even a fake home. Despite the fake settings for potential new products, their results are very real. Consider this: PG's company-wide operating margins are in excess of 19% with an astounding 5 year average return on equity of 38%. These types of business results are a testament to the Company's ability to build shareholder value over the long run by taking market share, innovating and maintaining massive brand awareness via its mammoth scale and unmatched world-wide distribution channels. Given that, we would feel comfortable adding to our PG positions in any sort of macroeconomic environment.

**Qualcomm F 12/05**

Qualcomm stock was fried in 2006. The company continues to shake and bake in the CDMA/WCDMA kitchen. And boy is it hot in there. Can they take the heat? We believe without a doubt they can and will. But judging by the stock's reaction in 2006 (-12% and down -23% in July), the marketplace is heavily discounting a reduction in Qualcomm's future royalty rate to be paid by their largest customer, Nokia. Qualcomm is currently in discussions with Nokia regarding an extension of their CDMA/WCDMA license agreement which expires April 9, 2007. If the existing agreement is not extended or a new agreement is not signed (Nokia retains an option until the end of 2008 to renew its current agreement), Nokia's right to sell CDMA and WCDMA handsets under most of Qualcomm's patents will cease as will royalties owed to Qualcomm. In addition, Qualcomm's right to sell integrated circuits under Nokia's patents will cease. Nokia has publicly stated that they

intend to continue selling the handsets and will accrue royalty payments pending a resolution. It is expected that Qualcomm will pursue and obtain injunctions against Nokia to disallow Nokia handsets utilizing Qualcomm CDMA/WCDMA patents to enter the U.S. broiling Nokia's U.S. revenue stream and exposing Nokia to revenue loss much greater than the loss of revenues at Qualcomm. It is widely believed that the disagreement will be resolved through negotiation rather than through the courts as Qualcomm has never had a court decide the licensing terms of a license. Qualcomm believes that if the Nokia stew ends up in courts they will have the upper hand because it is hard to see a court setting a precedent that allows a licensee to stop paying royalties in order to negotiate better terms before the old agreement expires. Qualcomm added that in other similar cases a court has typically awarded a higher royalty rate in order to discourage such behavior. Qualcomm has no other licensing agreements that expire before 2011 and in the next 10 years only has four license agreements that will expire. Nokia currently boasts a 35% WCDMA market share. Qualcomm estimates the impact on a loss of Nokia's royalties in both 2007 and 2008 on earnings at \$0.06 and \$0.28, respectively. As an aside, adding a little extra sugar (or spice) to Qualcomm's Nokia negotiations, Motorola the number-two handset maker in the world, recently agreed to Qualcomm's royalty terms and will utilize Qualcomm chips in future WCDMA phones. But, to add a dollop of cayenne pepper to the recipe... potentially ruining the dish and simmering Qualcomm's stock price, six major chipset makers (Nokia, Ericsson, Texas Instruments, NEC, Panasonic and Broadcom) filed complaints with European regulators related to the royalty practices imposed by Qualcomm. They contend that royalty rates should be based on the number of "essential" patents utilized in a standard such as WCDMA, not necessarily the value of each patent. Since Qualcomm's contribution to the WCDMA 3G wireless communications standard is not as great in number as their patent contribution to CDMA, the six companies believe Qualcomm should not receive the same royalty rate (4.5% of wholesale price of handset). Qualcomm contends that since the number of patents bears no relationship to patent value as the value of a patent is not just based on how many or how useful the patent may be, as its owner practices it, but also on how useful it may be to other firms for follow-on innovation, therefore the logic utilized by the six constituents is not applicable. In fact, Qualcomm has 105 "essential" WCDMA patents vs. 63 for Nokia, 163 for Ericsson, and 48 for Motorola. But, as chocolate chips are to chocolate chip cookies, the Qualcomm patents have received 62 citations per patent, versus 18 for Ericsson, 9 for Nokia, and 28 per Motorola patent. These patent citations (the chocolate chips) indicate that the more frequently and earlier a patent is cited, the greater the likelihood that the market rewards it with greater valuation.

Given Qualcomm receives royalties from over 70 companies bearing WCDMA licenses and Nokia has zero, the proof is in the pudding as to which company has a quality patent portfolio. It is expected that the European Union may take months, if not years to resolve. Qualcomm is expected to burn through \$200 million in legal fees in 2007 alone. Now on to something much more palatable. The zest of Qualcomm's business model is evident as Qualcomm's extensive R&D has produced technology for a myriad of licensees which has fostered a competitive environment whereby the CDMA/WCDMA standards are not dominated by just a couple of large handset original equipment manufacturers (OEM's). (The GSM standard has been dominated by Nokia and Motorola). Major handset WCDMA OEM's include Samsung, Panasonic, LG, Nokia, NEC and Motorola. Is it not evident that the market share dominance Nokia enjoyed with GSM has virtually been halved through Qualcomm's licensing/royalty structure in WCDMA which has enabled thriving competition? Qualcomm's technology has allowed faster time to market for vendors, a wider selection of handsets, lower handset average selling prices for operators and more benefits to end users. CDMA/WCDMA handset shipments are expected to reach 400 million in 2007, up from 117 million in 2003. This growth is outperforming both analog and GSM and has been supported on a worldwide basis. Qualcomm's geographic revenue breakdown is as follows: 13% U.S., 17% Europe and ROW, 17% China, 21% Japan and 32% South Korea. Fiscal 2006 saw Qualcomm's revenue rise 33% to \$7.53 billion, R&D rise 52% to \$1.54 billion, free cash flow rise 22% to \$2.57 billion, cash and equivalents on the balance sheet rise 15% to \$9.95 billion, and diluted earnings per share rise 14% to \$1.44. They also repurchased 34 million shares totaling \$1.49 billion. Now, we ask---what's cooking at Qualcomm and can they deliver the heat in 2007? Teledensity - or the number of people subscribing to wireless service - is expected to reach 3 billion people by the end of 2007. WCDMA handset sales are expected to reach 28% of total handset sales in 2007 with Western Europe, Japan, Taiwan, Hong Kong, and Indonesia leading the way. Twenty-five percent of the 170 million handsets sold in North America will be WCDMA. Once a technology reaches mid-teens penetration, the market tends to accelerate significantly. Qualcomm and their partners are currently trying to penetrate China, Russia, and India with lower priced handsets utilizing Qualcomm's technology and chipsets. In fact, in India there are more than 21 CDMA2000 handset models allowing data capabilities and internet penetration available from 10 suppliers for under \$50. At the other end of the spectrum, Qualcomm just announced a new chipset that will provide data rates of up to 28 Mbps on the downlink and 11 Mbps on the uplink. Look for Cingular, Verizon and Sprint to upgrade. LG Electronics won a GSM Association contract for WCDMA handsets at

the 3GSM congress held in Barcelona for +4 million phones at an average selling price of \$110.00. This competition was held in order to make feature rich handsets accessible to more consumers in developed and developing countries. Recent Qualcomm acquisitions of Airgo Networks and RF Microdevices have given Qualcomm competitive positions in the Wi-Fi chip market (for laptop and routers) and short-range Bluetooth connections. AT&T recently joined Verizon in selecting Qualcomm's MedioFlo for mobile entertainment services. Verizon will rollout the service in first quarter 2007. Sprint and T-Mobile are in trials at the present time. MedioFlo is expected to have a substantial impact on chipset sales in 2008. Per Qualcomm, MedioFlo aggregates and will deliver premium, TV quality entertainment and information services to mobile phones over its dedicated nationwide wireless network. This will include full-length programming, short-format clips and real-time information and entertainment feeds. MTV, ESPN, Fox, NBC, CBS are some of the names providing content. MediaFlo is also being rolled out in the U.K. and Japan. Given Qualcomm's leading patent position (chipset innovation) which is driving licensing and royalties, Qualcomm has over 70 WCDMA licenses and 120 CDMA2000 licenses. With the growth in 3G and the potential for a number of 3G license agreements in Brazil, Russia, India and China, we remain positive on Qualcomm shares. A resolution to the Nokia in 2007 will also be a catalyst for Qualcomm as well as their positioning in Mobile media, Wi-Fi, WiMax and next generation Bluetooth technologies. Qualcomm recently teamed with Hewlett Packard, Dell and Lenovo to launch notebooks that support WiMax efforts. The shares are trading at 23x estimated 2007 earnings of \$1.62, below the industry group average. With the \$6.40 per share of cash and marketable securities, the shares are trading at an appetizing 20X 2007 earnings resulting in a PE/G ratio of 1.1. All of our portfolios have been served up with a hefty portion of Qualcomm shares.

**SLM Corp. F 3/04**

The stock was down -12% in 2006... and got worse as 2007 began. The private student lending industry received a heavy dose of bad economic and political news on Monday, February 5<sup>th</sup> when the Bush administration unveiled its 2008 budget. Specifically, and most surprising, the budget calls for a 50 basis point reduction in the government subsidy that it pays student lenders. (In addition, the budget calls for other fee reductions as well.) With this surprising announcement, all told, with the prospective earnings reduction (which, let us state up front, we believe is quite manageable for Sallie Mae), as well as a sharp increase in political uncertainty, the shares of the three publicly traded student lenders (Student Loan Corp. and Nelnet) declined sharply. On the day of the news, Sallie Mae suffered its worst single day decline in many

years, falling -\$4.00 per share. Obviously at this point we must assess just how “bad” this bad news is and how much of the news is priced into the shares of Sallie Mae. But first, a bit of background information is necessary to frame our opinion. Sallie Mae began its private corporate life in 1972 as a chartered government agency as the Student Loan Marketing Association (or SLMA – hence its long-standing nickname “Sallie Mae”). Up until the early 1990’s the company’s sole business was the purchasing and servicing of government guaranteed Stafford student loans under the aegis of the Federal Family Higher Education Loan Program (FFELP). The FFELP facilitates student lending by guaranteeing the principal and interest - as well as an interest rate spread - to private student lenders and servicers such as Sallie Mae. Given the political and economic changes to the Stafford loan program since 1993, the company has had to reorient its business model twice; and likely a third time considering the budgetary reality of the related House bill (HR-5) and the President’s budget proposal. The first reorientation was caused by a political tsunami from the Clinton administration. Sallie Mae, an inherently “political” creature battled the first industry shock when, in 1993, the Clinton administration ushered in a non-private federal government alternative called the William D. Ford Direct Lending Program (DL). The stated goals of the DL program were quite ambitious and at the time seemed like the death-knell to private FFEL program (see the split-adjusted 1988-1998 chart below – particularly early 1993). Specifically, the supporters of the DL program (Senator Kennedy being the most vocal then and now) promised in 1993 to save the government \$5 billion dollars, while capturing 60% market share of Stafford loans (more on these political/economic promises in a bit). Obviously, the government giveth and the government can taketh away, so Sallie Mae decided to broaden its array of student-lending business lines away from the FFEL program soon after the enactment of the DL. Sallie Mae’s path to independence and diversity took quite a few years – and was not a small task. So in 1994 Sallie Mae began the arduous process of seeking to receive approval to remove and wind down its charter as a government special enterprise (GSE). By 1999, the company completed this process (which included the not-so-small task of refinancing its considerably large balance sheet with an investment grade rating). The second reorientation has transpired over the past few years involving two significant changes for the company. The first was industry related as students have been allowed to consolidate Stafford loans into a single loan at the lowest prevailing rates. As you can well imagine, consolidation reduces lenders margins. To-date, 70% (\$80 billion of insured) of loans have been consolidated on the company’s balance sheet and once again the company has managed a difficult issue quite well in terms of minimizing margin erosion. As with any changes within the FFEL program, there can also

emerge silver linings. Such is the case with consolidated loans. The company has borne the brunt of the margin compression of consolidated loans, but the average life of these loans is now 2.2 times the life of an unconsolidated loan. The second issue that investors have wrung their respective hands over of late is the company's determination to become less reliant on originations from outside partners. The most significant being the termination of channel partner the J.P. MorganChase/Banc One group. As of just last few years, this group accounted for nearly 40% of the company's loan production. Today, 70% of the company's originations are generated by internal brands. So, before we go any further, let's take stock on what Sallie Mae has accomplished over the past 34 years. Sallie Mae is the number one provider of student loan credit in the U.S. They are the largest provider of student loan credit in both private and federal loans. They are the largest in consolidated, undergraduate and graduate student loans. They service (partially or whole) loans for 9 out the 35 student loan guarantors in the marketplace. Sallie Mae's market share is by far the industry's largest at 23%. Their student loan assets have grown to \$145 billion. Back in just 1999, over 90% of the company's earning assets were in the FFEL program. Since then, the company has been uniquely successful in diversifying their business model as current business lines include FFELP Stafford loans (43% of revenues), private student loans (23% of revenues) and student loan fee-related operations (35% of revenues). Over this same time frame the company's annual earnings growth have never fallen below 15% - compounding at 19%. (The fact that the company has never posted a negative earnings quarter since becoming a public company is powerful testimony to the company's outstanding business franchise.) In 1999, the company generated \$40 million in fee-based revenues. In 2006, fee-related businesses grew 21% to just over \$1 billion. The company's annuity-like fee-based businesses now cover over 90% of the company's entire expense structure. The Stafford (either the FFELP or DL) does not provide nearly enough financing for the entire cost of even a modest college or university. Student loan gap financing is a must. (An aside: George Washington University just announced their 2007 tuition/room and board - they are the first to crack the \$50,000 per year.) Sallie Mae is the largest provider of private student loan credit in the country. 80% of the company's private loan origination comes from their extensive network of campus-based contacts. Private loans are growing in excess of 20% and the company has been quite conservative in growing this part of their business. Now on to the matter at hand: Will Sallie Mae's past be prologue? We think so. Why? Four salient reasons: (1) If HR-5 and the President's budget proposal both remain unchanged through the upcoming Senate debate, the hit to the company's earnings will be exceedingly manageable - just a few cents in 2007 and as

much as \$.35 in 2008. Off an earnings base of \$3.35 and \$3.85 pre-HR-5/Bush in 2007 and 2008 respectively, we believe such less-than-draconian earnings reduction speak to the company's outstanding business franchise. (2) If HR-5 and the President's budget proposal stands, we believe many smaller players will exit the student-loan business. Businesses with razor-thin margins require enormous scale and scope to turn a profit, much less outstanding profits of the likes of Sallie Mae. Sallie Mae will invest \$200 million alone in 2007 on technology and infrastructure to support their +400 sales forces. Sallie Mae could well find themselves as buyer of first (if not last) resort in any ensuing industry shakeout. In fact, the recent repeal of the single-holder rule alone opens up a new pipeline of tens of billions of potential loans that the company can now purchase from weaker competitors. (3) The FFELP is not going away – at least anytime soon. The FFELP has been a terrific public/private partnership. Remember the promises of the DL program back in 1993? Well. Instead of capturing 60% of the market the DL program peaked at 32% and now stands at just 20%. Out of 6,000 participating colleges and universities, 4,800 have chosen the FFEL program over the DL program. Since its inception, instead of saving the government \$5 billion, the DL program has cost the government **\$21 billion**. Furthermore, the FFEL program has reduced default rates on federal loans from 15% in the early '90's to 5% today. (4) Future growth abounds. The demand for college education remains robust. Of those people in the U.S. over the age of 28, only 27% of this population has a college degree. This country has increasingly become stratified between economic have and have-nots. Education is the great divider. The largest high school graduated class will occur in 2009. Demographics points to college enrollment increases through at least 2015. We believe the hit to the stock was driven more by an increase in political uncertainty than the relatively small decline in earnings. As it stands now, Sallie Mae's business model is a 15% grower - generating returns on equity of at least 30% (a most enviable business model). At current valuations the stock is trading at just 12X new 2008 earnings expectations of approximately \$3.50. The significant discount to the market is solely, in our view, borne of political uncertainty and fully priced into the stock. We remain buyers. Logical ultimately prevailed when an offer to purchase the company was put forth by a consortium of Bank of America, J.P. MorganChase and a private equity firm. We sold the shares in the mid-\$50's.

of different cultures, top management turnover, lack of client focus and an unfocused technological focus has resulted in poor employee moral, poor client service, key client defections and a sharp drop in profitability. We exited these shares smitten at the large mistake we made by not selling sooner. We held on at the depths of the doom and gloom in Nextel shares in that forgettable year of 2002, yet gave too much back. Major F!!

**Sysco**            **C**            **9/04**

Sysco exited the portfolio during 2006. One of the Wedgewood sell disciplines entails parting ways with a company if a better opportunity arises. Sysco happened to fall into that category. Sysco originally looked attractive to us based upon its dominant position in the food distribution industry. The company had a proven track record of steadily posting double digit growth and an impressive streak of returning over 30% on shareholder equity. However, given that Sysco operates in the fairly mature food services industry, double digit growth is difficult to attain without the help of a handful of percentage points due to acquisition on an annual basis. Also, during late 2005 and early 2006 the company announced that its massive distribution centers, designed to wring operational efficiencies out of existing routes, would continue to drag on earnings. We expect non-acquisition longer-term growth rates falling into the single digits. We exited the stock in favor of Wm. Wrigley, which we believed, despite recent acquisitions, had a better long-term growth profile.

**Varian  
Medical  
Systems**            **D**            **6/05**

Varian Medical System shares have been under quite a bit a pressure of late due to poor earnings. Earnings have no doubt disappointed, but certainly not for lack of business. The company's backlog currently stands at \$1.8 billion. The issue behind the poor earnings is that the company only recognizes revenue once their equipment is installed. Given the increased size and complexity of the company's radiotherapy machines, plus the incremental construction/renovation necessary at the installation site, installation times have increased. We remain quite bullish on this company and with the recent decline in these shares we believe a review and business primer is in order. From the Varian Medical Systems 2006 annual report: *Radiation therapy or radiotherapy is used in the treatment of cancer, either alone or in combination with surgery or chemotherapy. When cancer cells absorb radiation, this inhibits replication leading to the cancerous cells death. Image guided radiotherapy is an advanced form of radiation therapy in which the intensity and angle of the radiation beams from a linear accelerator are varied conforming the radiation beams more closely to the shape of the tumor allowing doctors to deliver higher doses of radiation to tumors while limiting the amount of radiation directed at nearby healthy tissue. Image guided*

radiotherapy (IGRT) is the most advanced radiation therapy technology that complements intensity modulated radiation therapy (IMRT) to further enhance radiation therapy treatments. IGRT goes the next step of allowing doctors to accommodate for tumor movement and avoid more healthy tissue that otherwise would be irradiated when a tumor moves or shrinks thereby allowing doctors to deliver higher more precise doses. Stereo tactic radiosurgery (image guided radiosurgery) is an advanced radiation treatment procedure that employs linear accelerators and IGRT technology to eradicate cancerous and non cancerous lesions anywhere in the body by delivering a few very precisely placed high dose beams of radiation. Brachytherapy treatments involve the insertion of radioactive seeds, wire or ribbons directly into a tumor or into a body cavity close to the cancerous area thereby sparing healthy tissue afflicted with external beam radiation. This is used primarily for cancers of the head, neck, breast, uterus, thyroid, cervix and prostate. Varian Medical Systems is a \$6.5 billion market cap company producing 2006 revenues of \$1.8 billion. The company has created considerable competitive advantages through technological advances in radiotherapy cancer treatment, flat panel digital image detectors for film less X-rays and linear accelerators for security and inspection purposes, amassing them a 70% worldwide market share. Oncology systems, which produces 85% of revenues with \$1.5 billion in orders and X-ray products which is growing due to the flat-panel portion. In fiscal 2006, Varian grew overall revenues by 14%, operating earnings grew 15%, and net earnings rose 22%. Overall the company performed on cue with 60% of new orders for high energy accelerators including the On-Board Imager which helps medical teams image and target tumors more accurately. Advanced IGRT stereotactic technology ensures more effective treatments for cancer patients and many cancer treatment centers in the U.S. eminently need to have the most up-to-date technology in order to compete for patients who demand the best treatments available to fight cancer for themselves and their loved ones. Due to the unfortunate rising incidence of cancer, an underserved worldwide market, ongoing acceptance of IGRT, new applications in radiotherapy for cancer treatment, and contributions from their flat-panel imager and security and inspections business, Varian believes it can produce \$3 billion in revenues by 2011. Half of all cancer patients receive some form of radiation therapy. The World Cancer Report stated that annual rates of cancer are projected to increase by 50% to 15 million new cases in the year 2020 due to an aging population, unhealthy lifestyles and increasing rates of smoking worldwide. In the U.S. alone, there are 1.4 million new cancer patients each year, 2.9 million in the European Union and 6.6 million in the rest of the world. The population is aging, as there are currently 36 million people over 65 in the U.S. today. This figure is expected to grow to 48 million by 2015. In China, there are over 100

million people above the age of 65. As the population grows older, the incidence of cancer increases. As disturbing as the facts are, the tobacco industry in China is state controlled and tobacco money is used to enrich and improve the lives of their citizens with the building of highways, railroads, hotels, sporting complexes, dams and various other public works projects. After five decades of sophisticated marketing to coerce the public into smoking, the ugly truth of the harmful effects of smoking has come to the fore as China has 350 million smokers - more than one million people a year die from smoking related diseases. China's smoking-related death toll is expected to more than double by 2025. Varian is currently building a 125,000 square foot manufacturing facility for their linear accelerators in Beijing, China to address the huge assortment of smoking related cancers, as well as China's aging population. In North America, there are about 13 radiotherapy units per million people and the need is estimated at 15 per million due to factors listed above. In Western Europe, the number of units needed are estimated at 6.7 per million, but the supply is only 4.7 per million. In Asia, given the huge population, there are currently 700 radiotherapy machines in use. Asia is short by about 10,000 units given the recommended ratio of four machines per million people. IGRT adoption is occurring three times faster than Varian experienced with IMRT (Intensity Modulated Radiation Therapy). Varian's On-Board Imager device for Image-guided radiotherapy (IGRT) and image-guided radiosurgery (IGRS) were among the top 100 new product designs recognized by *R&D Magazine* in 2006. At the end of 2006, more than 325 installations of the Onboard imager product for high energy Clinac accelerators and Trilogy linear accelerators were completed. North America continues to be a worldwide leader in the adoption of IGRT. Increased opportunities exist for the use of radiotherapy beyond traditional cancers such as prostate and breast cancer as well as areas of the neck, brain, lung, and head. Image guidance is being used to treat every type of cancer normally treated with radiotherapy, and many doctors expect that they will be using it on all of their patients. Fully loaded, the IGRT system sells for \$3 million dollars. Varian customers continue to migrate to the more expensive IGRT system for which switching costs are extremely high. Typically, customers recoup their investment within 12-18 months of use. Net orders and shipments for Varian's flat panel imager were about twice the totals for the previous year as demand grew for film less X-ray systems capable of faster, more cost-efficient medical diagnostics and procedures, dental imaging, veterinary care and industrial inspection. This portion of the business is expected to grow larger than the X-ray tube division within five years as demand for digital imaging technology increases. Cargo screening at seaports, airports, and border crossings worldwide is increasing as corollary fears of suspicious materials entering a country

through terrorist activities are rising. The X-ray machines that Varian produces for their linear accelerators are capable of X-raying cargo containers and trucks and can detect weapons of mass destruction. Varian's Linatron K9 dual-energy linac can scan an entire cargo container in less than one minute. The high energy linacs sell for \$500,000-\$1,000,000. With 361 points of entry into the U.S., we only have 10 of these linear accelerators in use. There are about 130 linacs outside of the U.S. The huge upside potential for this technology should drive double digit revenue growth in this segment over the next ten years. Varian is well-positioned to benefit from the Security and Accountability for Every (SAFE) Port Act which was signed into law in the U.S. on October 13<sup>th</sup>. This law requires the use of radiation screening for all imported containers passing through the 22 largest U.S. ports within 12 months. We continue to see double digit mid-teen growth for Varian as the company continues to innovate creating new and more effective radiotherapy treatments for cancer. High barriers to entry including high initial investment and government regulations protect Varian's competitive position. Varian currently trades at a significant discount to its peer group offering an attractive risk/reward profile for 2007.

<b>Western Union</b>	<b>B</b>	<b>10/06</b>	<p>We finally got our hands on these shares. Western Union was spun off from First Data in October last year. Western Union has been the crown jewel inside First Data for years. We were delighted to hear about the spin-off from FDC management during the first part of 2006, as no doubt the majority of FDC's growth in operating performance and cash generation relied on the WU engine. The last full year of WU-FDC results (2005) had WU generating an obscene \$1 billion in free cash flow on a measly \$40 million in capex! When a business model can be levered to generate those types of returns, surely it deserves to trade at a premium – a premium which we believe was being stunted by the rest of FDC's low margin, slow growth credit card processing businesses. So as usual, we believe a bit of background is due to the newly formed WU standalone. Western Union provides a range of money transfer and bill payment services worldwide. Of these businesses, namely, the consumer-to-consumer money transferring business is where WU's heart beats. This business possess an unrivaled, 155 year-old brand that has allowed it to command a 15% market share in an industry that allows entry to a competitor with functionality as simple as an ACH. As an independent company WU is free to set their own course. Western Union is arguably the most</p>
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recognized brand in the world. The company's familiar black and yellow signage is displayed at over 300,000 agents worldwide – up from 120,000 in 2001 and 36,000 in 1996. The “story” on the company could not be more straightforward. The global cash remittance business is vast. Nearly 200 million people reside outside their country of origin. The quest for a better life is innate. The movement of immigrants to more prosperous countries is never ending. The U.S. has the largest immigrant population (38 million) in the world. No other company has the history, size, scale, scope, network and technology than Western Union. The market clearly remains underserved, as immigration (immigrants are the dominant customers of money xfer business) remains a function of the rapidly widening wealth gap between countries of employment and countries of repatriation. But to serve these customers, Western Union harnesses the said network of over 300,000 money transferring agents worldwide. So, given this networking (aka compounding) effect, each additional agent is 300,000+ times more effective. As a result, this type of model is very scalable, meaning it doesn't cost much to add or subtract capacity, based upon increasing or slowing demand for money transfers. During 2006, Western Union processed five times the volume as its nearest competitor, while sourcing nearly 50% of its revenues overseas. Yet the company has only captured 18% global market share. The company is a cash-generating machine with operating margins of 30%. Cash flow as a percent of sales (one of our favorite profitability metrics) is an outstanding 24%. Spending nearly \$290 million in marketing (7% of revenues), Western Union has self-enabled one of the most trusted, established brand names in the highly fragmented money transfer businesses. We believe the Company will continue to build upon its illustrative history as their scalability is second to none and network of agents is over three times that of their closest competitor. These qualities alone, we believe, warrant a premium to not only the market but also its peers. (The following Western Union “firsts” may come in handy for Trivia Nights). First transcontinental telegraph (1856). First stock ticker (1869). One of the original 11 stocks in the Dow Jones Industrial Average (1884). First consumer charge card (1914). First singing telegram (1933). First facsimile machine (1935). First inter-city microwave system (1943). First direct-dial teleprinter service – Telex (1958). First commercial satellite (1974). First branded, pre-paid telephone card (1993).

**Whole  
Foods  
Market**

**D 7/06**

We have long watched this terrific company to be eager owners. Valuation was the inhibiting factor. 2006 brought a good deal of change for the company and its stock. Whole Foods stock was pummeled in 2006, falling 37% due to the markets joint concerns of permanently reduced top-line growth and comparable store growth in combination with lower operating margins resulting from higher than expected pre-opening expenses of new stores. Recognizing this as an opportunity to add this name to our portfolios, we established positions in July and September of 2006 with an average cost in the low 50's. The stock appeals to us based on what we see as a terrifically - managed company focused solely on the long-term. The company has huge opportunities for expansion on a national and worldwide basis. Their markets are untapped and demand for organic and natural food is growing at very attractive rates. Whole Food Markets is addressing their need to reestablish higher growth rates by increasing their square footage growth in 2007 and 2008 with more and larger stores, combined with reduced cannibalization of existing stores. The company cautioned that 2007 would be a transitional year as its growth rate reverted to historical norms. The company has averaged 20.7% sales growth over the past five years with fiscal 2006 sales increasing 19%. Whole Foods Market is a leading global retailer of high quality natural and organic foods offering produce, seafood, grocery, meat and poultry, bakery, prepared foods, catering, beer, wine, cheese, whole body, floral, pet products and household products. The first store was opened in Austin, TX with 19 employees in 1980 with the merger of Safeway (owned and operated by current CEO John Mackey and Rene Lawson.) and Clarksville Natural Grocery. The company has grown to over 39,000 employees with 189 stores located in the U.S., Canada and the U.K. Since the early 1990s, the retail market for organic foods in developed countries has been growing by about 20% annually due to increasing consumer demand spurred by concern for the safety of food and the reality of environmental damage from traditional farming techniques. Future growth estimates range from 10-50% annually depending on the country. Sales of conventional food, while easily dwarfing sales of organic/natural foods (\$550 billion vs. \$20 billion) – are growing at a tortoise like pace of 2%-3% per year. Whole Foods in contrast, by following their growth strategy of growing from new store openings, acquisitions (24% of existing square footage) and comparable store sales growth, has realized 32% annual compound growth since 1991. Sales in 1991 amounted to \$92 million and reached close to \$6 billion in 2006. Management's target for sales in 2010 is \$12 billion. A typical Whole Foods store is a marvel of profitability. An average Whole Foods Market store size is 32,000 square feet and generates weekly store sales of \$593,439, easily outstripping a typical grocery stores average weekly sales

of \$300,000. A Whole Foods store is also more profitable with operating cash flow equal to 8% of sales versus 3%-5% for a typical grocer. As the stores mature, return on invested capital increases dramatically. Stores over 11 years old have ROIC of 84%, stores 8-11 years old have ROIC of 69%, stores 5-8 years old realize ROIC of 44%, between 2-5 years old have ROIC on average of 25% and less than two 4%. As of November 9, 2006, Whole Foods had signed leases for 65 stores averaging 55,000 square feet in size, which is approximately 64% larger than the average size of the existing store base. A larger store is believed to be less vulnerable to competition. New stores in various stages of development represent 3.7 million square feet, 60% of the existing 6.3 million square feet currently in stores. The Whole Foods store does not have a standard store design, as each store is customized to the community in which it operates. Stores are located in high-traffic shopping areas and potential sites are based on education levels, income levels and population density. New store average investment over the last two years has averaged \$11.6 million in addition to pre-opening costs of \$1.5 million per store. Whole Foods aims to distinguish their stores and increase their customer base by making the shopping experience more enjoyable for their customers. Is there anything more boring than shopping at Wal-Mart? Marketing efforts and expenses are miniscule amounting to 0.4% of total sales and are expended utilizing taste fairs, classes, tours and product samplings thereby creating word of mouth "buzz". Whole Foods also enhances the shopping experience through their huge selection of high-quality, fresh perishables-produce, dairy, meat, seafood, bakery and prepared foods. These high-margin items account for over 68% of total retail sales. Another market opportunity Whole Foods has capitalized on exists due to a lack of any national brands within the natural products category. Whole Foods offers four corporate brands within their private label (365 Everyday Value, Whole Kids Organic, 365 Organic and the Whole Brands family) These brands offer 1500 SKU's, they appeal to the value conscious and account for 15% of total sales. Product purchases are made from local, regional and international wholesale suppliers with a focus on local products to enhance the quality, freshness and neighborhood market appeal. As an aside, for the last eight years, Whole Foods Markets has been selected as one of Fortune magazine's 100 Best Companies to Work for in America. Ninety percent of their employees are full-time and all part-time and full-time employees are eligible to receive stock options thereby aligning the interests of each and every employee with those of all stakeholders. While still trading at a hefty 31X's 07 reduced EPS of \$1.54, above both industry mean and median, we believe there is plenty of growth left in this food story. In an effort to reduce competition and drive sales growth, on February 21<sup>st</sup>, 2007, Whole Foods announced that they sign a definitive merger agreement whereby they would acquire Wild Oats Markets' outstanding common

stock in a cash tender offer of \$18.50 per share, or approximately \$565 million based on fully diluted shares. Whole Foods as Wild Oats has 110 stores producing only one – half the square footage sales as Whole Foods Market and the Wild Oats stores are located in regions not dominated by Whole Foods; Florida, the Northwest and Rocky mountain states. Whole Foods Market is the world's leading retailer of natural and organic foods, with almost 200 stores in North America and the United Kingdom. Their philosophy of offering high quality, minimally processed, naturally preserved goods, caters to a rapidly growing minority of the population that follows a healthy, nutritious lifestyle. However, the stock has been battered during the first quarter of the year. Why? There are three distinct reasons. Firstly, WFMI recently tendered an offer for all outstanding shares of Wild Oats Markets, Inc. (OATS). OATS is an outfit with a very similar target market and philosophy, albeit with much less operating leverage (about half of WFMI's sales per sq foot). The OATS acquisition will penetrate WFMI's presence into several un-served markets by modifying OATS' anemic operational layout in favor of the robust WFMI format. As a result we believe the merger to be a great move; however, the tender offer is contingent upon regulatory approval, via the FTC. During the most recent quarterly results, WFMI's management noted that the FTC had expressed concerns about the merger, but would not elaborate. So, much of the sell-off was due to the introduction of the *possibility* of the deal not going through. But to assess the *probability* of the deal being blocked, consider the following: WFMI and OATS' combined 2006 sales were about \$7 billion. The supermarket industry is close to one half trillion dollars in sales per annum, making the resulting Company responsible for 1.4% of the market. Further, citing Morningstar's analysis, the resulting merged WFMI would still only have a 20% share of the organics and nutrition sub-industry. The FTC has a history of blessing much more questionable match-ups, so we view the blockage of this merger as highly improbable. Secondly, given that the retail industry's performance heuristic is "comps" or same-store sales, when WFMI put up 6% "comps," not to mention linked to quarter over quarter *double digit comps*, it was greeted as an unacceptable rate. With the sell-off the stock, the Market has thus concluded that WFMI's growth is no longer at an upward trajectory for its investment horizon. But to refute the accusation of a falling long-term growth trajectory at Whole Foods, consider the following: there are more metrics to growth than just "comps." As is true with any business, if growth is slowing, cash coffers shrink with any excess capital and infrastructural build-out. This is *clearly* not the case at Whole Foods. This chart displays WFMI and its more mature peers' square footage growth (including sq. footage under development) over the past 3 years through 1q07. The differences are not subtle. When the returns on capital are in excess of their costs, the business should reinvest its cash, and quick, because

competition is always lurking. WFMI is piling into new stores because its store base's (average age of 7 years) average returns on investment are over 40%. With that type of excess capital return, a stock ought to be awarded a premium. This segues us into the third and final reason why WFMI is down...valuation. There has been a barrage of commentary accusing WFMI of being too pricey on a P/E basis. That may be true at 25x next year's earnings. However, given the capital intensity and expensive nature of opening new stores (outlays are expensed, not capitalized), WFMI's earnings are riddled with holes after it runs the GAAP gauntlet. Alternatively, pulling the curtain back on WFMI's price to cash flow ratio reveals the stock trades at a paltry 11x its cash flows. In comparison with 15 times cash flows for the S&P 500 and in-line with its peer group of grocery stores. WFMI's 5 year average P/CF is almost 20x. Just to take cash one step further, its cash flow yield (i.e. if WFMI were a bond) is roughly 7.5%. In conclusion, we believe, penalization for reinvesting in growth is most certainly an "anomaly." We believe the recent sell-off to be a classic example of Werner De Bondt and Richard Thaler's ubiquitous *representative bias* -- first cited in a 1985 Journal of Finance study that linked a common psychology concept and applied it to market pricing. Their findings argued that "investors overreact to both bad news and good news...therefore, overreactions leads past losers to become under priced and past winners to become overpriced" (Shefrin 8). The market obviously over-reacted to this news with probability aside, heuristics in hand and therefore, we remain buyers of WFMI.

**Wrigley**

**B**

**4/06**

We have long admired Wrigley as the company has managed to compound its 100+ years of history, marketing and innovation into one of the world's most distinguished and valuable brand names. This type of branding, among other things, has allowed the Company to proliferate a worldwide distribution system that spans over 180 countries. As Wrigley's distribution emplacement has moved overseas, core volume growth has reliably increased on a high single-digit basis, dripping down to a mid-teen double digit eps growth rate. As a result we think the company possesses a terrific global franchise. Our entry point in the stock came on the back of the company's bumpy digestion of their purchase of the Life Saver, Crème Savers and Altoids brand. The stock, which historically trades at a (well-deserved) premium, has been relatively flat over the past five years. Yet revenues have compounded at a healthy 14% clip over the same time frame. While the company enjoys a 60% market share in the U.S., the dynamic growth is coming entirely international. Sales in India were up 24% in 2006. Eastern and Central Europe were up 9%. Asia, led by China was up 23%. Speaking of China, the company distributes at 2.2 million points of sale. (As compared to 2.1 million for Coca-Cola, 2 million for Colgate toothpaste, 1.6 million for P&G shampoo and less than 100,000 for their leading gum

competitor. Until recently, Wrigley's century-plus effort has been purely organic. The impetus for this non-acquisitive strategy was, likely, due to the high domestic volume growth that the Company enjoyed for so long. Internal growth has been just as "organic." A Wrigley Family member has been at the helm since day one, so the internal cultural make-up of the Company has viewed outsiders as having little - if any - room to "infiltrate" its storied history. However, the company embarked on a significant management change in 2006 with the announcement of William Perez as the first non-Wrigley as CEO. Mr. Perez spent more than 30 years at the consumer powerhouse S.C. Johnson, including eight years as CEO. Mr. Perez was responsible for building S.C. Johnson's international sales. Addressing Wrigley's shareholders for the first time. Mr. Perez summed up the Wrigley story quite well: *"SO IN SUMMARY, I THINK THERE'S A LOT TO LIKE ABOUT THE WRIGLEY COMPANY, OUR CULTURE, OUR BRANDS, OUR DISTRIBUTION INFRASTRUCTURE, OUR FRONT-END MERCHANDISING EXPERTISE, OUR GEOGRAPHIC PRESENCE, OUR INNOVATION PIPELINE, AND THE STRENGTH OF THE GUM CATEGORY. AND AT THE SAME TIME, WE HAVE A NUMBER OF OPPORTUNITIES TO TAKE OUR PERFORMANCE TO AN EVEN HIGHER LEVEL, IMPROVING OUR MARKET SHARES, MANAGING OUR EXPENSES AND GROSS MARGINS, TRANSLATING OUR CHECKOUT STRENGTH TO THE CENTER OF THE STORE, AND BEING SELECTIVE IN THE PURSUIT OF OPPORTUNITIES."* We believe Perez represents a great seasoned addition and given his background, appears to understand the importance and value of a family brand name. Going forward, we believe Wrigley will continue its game plan of overseas dominance, further diminishing, as a percentage of total WWY sales, their saturated, domestic presence (currently 30%).

Yahoo

C

5/06

With a quick start in 2007 and Yahoo! up 25%, 2006 is a year that we would like to be as far removed from as possible given Yahoo! ended the year down @ 13% from our average purchase price. Why the disconnect between what we saw as an attractive entry point for the stock in late May and the stock's subsequent poor performance? Primarily, the announcement in July (stock fell 22% that day) that Yahoo's new search monetization initiative labeled Project Panama would not be launched until 1H07 delaying the 20%-30% re-acceleration in paid search revenues expected by the street. Yahoo derives 87% of their revenues (\$3.7 billion.) from marketing services of which approximately ½ of this (\$1.8 billion.) is from search and the incremental revenue from Panama is expected to be a key driver of growth for Yahoo! in 2008-2009. Search advertising is growing 40% per year while branded advertising growth is declining to the mid 20% range. What this means is that search will consume more of online ad dollars per year as both the industry grows as well as

growth in advertisers search dollars thereby making Project Panama Yahoo's life cord. Recent reports indicated that online retailers get 25% of their shopping traffic from search, 9% from email, and 5% from social networks. Project Panama, Yahoo's #1 R&D priority for the last two years, will allow Yahoo to compete more effectively with Google by offering new search campaign management tools and monetization improvements. Improved search campaign management tools will make it easier and faster for advertisers to set up and test the ad, use geographic targeting as well as determining what is and what is not working. The launch of this first part of Project Panama to advertisers has been met with aplomb. The new ranking model will shift from sorting results based on maximum bid price to sorting results based on a series of factors, including maximum bid price and relevancy. In effect, relevancy determines if a user "clicks thru" the ad thereby producing revenues for Yahoo!. Also, the click thru rate determines the price paid per click. Reportedly, Yahoo currently generates \$0.04 per US search while Google generates \$0.11. These figures belie the dismal economics and previous inferior efforts on the part of Yahoo, landing it in the stable number two spot in search with a 28% market share. Industry pundits expect global online advertising to grow to \$55 billion by 2010 underscoring the huge potential Yahoo! has if they get it right. Although Yahoo! has many more initiatives to drive revenue growth, it is Project Panama that will make or break the stock in 2007. So far the reviews from advertisers have been overwhelmingly positive and internal checks indicate Panama's algorithm change was smooth and total spend has increased modestly from pre-to-post Panama levels. As a top web portal, Yahoo is a world leader in terms of traffic, user reach, advertising and brand recognition. The latest reporting period (third quarter '06) saw revenues increase 19% year over year, with unique users up 19% year over year, fee paying users up 36% (15.5 million), new page views up 24% and search up 21%. The increase in the volume of page views and searches can be attributed to an increased number of users, an increased number of affiliates, and an expanded offering of properties which increased Yahoo's inventory of page views. The growing number of users, advertisers and inventory has been driving the increase in marketing service revenues. Over the past year, Yahoo has traded at an EV/EBITDA multiple of between 9x-23x with an average of 14x. Currently, Yahoo is trading at 16x 2007 EV/EBITDA. If Project Panama delivers and revenue and EBITDA growth accelerates as a result, we look for Yahoo's EV/EBITDA multiple to expand offering weary shareholders relief.

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