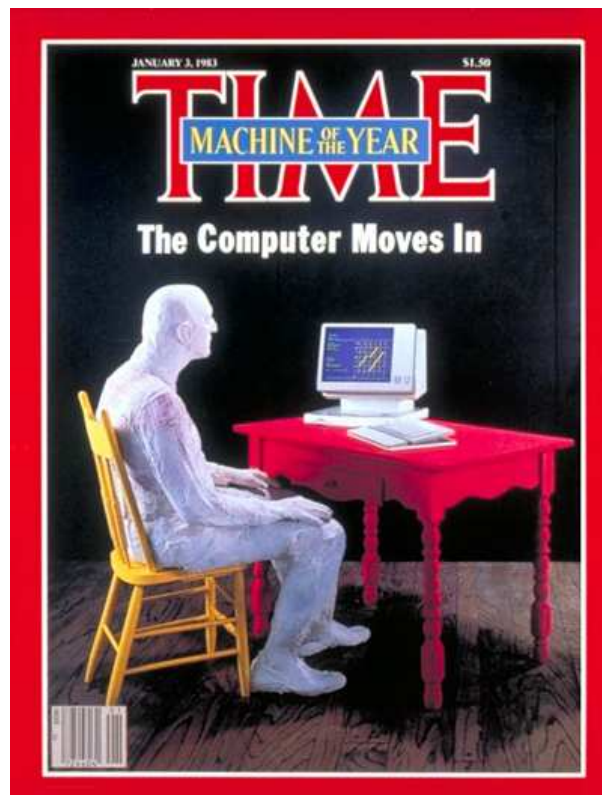


WEDGEWOOD VIEW. 2nd QUARTER 2007

iPhone: Machine of the Year



IBM did it in 1983. We believe that Apple will do it with the iPhone in 2007.

Have you heard that Apple is going to launch a new cell phone?

We thought so.

(The New York Times reports that over the last six months, the iPhone has been the subject of 11,000 print articles and over 69 million hits on Google.)

In what is arguably the most anticipated technology product launch since Windows 95, Apple Inc., (note: no longer Apple Computer) will begin selling the iPhone at 6:00 PM on June 29th.

The hype and hyperbole over the iPhone has been such that a skeptic might suspect that expectations are so high on this so-called “revolutionary” device that it is doomed to disappoint all but the most die-hard Apple fans. Perhaps. But we don’t think so. In fact, despite the early glowing reviews thus far, and the gee-whiz ads (see for yourself: <http://www.apple.com/iphone/usingiphone/guidedtour.html> and here <http://www.apple.com/iphone/ads/ad1/>), we believe the iPhone will be in fact a quantum leap in the ever evolving description and maturation of the “smartphone” market.

We have endeavored to follow the development of the iPhone beginning through the maze of countless patents (+200) filed by Apple over the past few years, through the official announcement of the iPhone by Steve Jobs earlier this year on January 9th. In short, we ardently believe that Apple’s first noted leap in user experience - with their commercialization of the first computer graphical mouse-and-menu interface with the release of the Macintosh in 1984 - has once again been accomplished with the iPhone. As we endeavor to explain in this Letter, the iPhone is clearly a redefinition of a smartphone, but behind the amazing plethora of interrelated applications is a touch screen (user interface) so advanced, yet so simple to use, that seeing is truly believing.

Apple makes intuitive products. You can open the box and figure them out in two minutes. We can learn from Apple and make things easier to use.

Joseph Taylor, executive VP/COO at Panasonic

In our first Letter on Apple (Winter 2005) we wrote the following:

Ironically, where once the company’s 30-year history of independent hardware and software development – regularly in coordination with each other – was without a doubt a limiting factor to growth, operating leverage and profitability, we believe, if not paradoxically so, that such tight hardware and software development and integration has morphed into not only the company’s greatest competitive advantage, but arguably the company’s “crown jewel.” In this reversal of fortune, Apple is now the only major PC company that is vertically integrated – profitability does not lie. Apple has the highest operating margins of any major PC company.

The concomitant design of hardware and software is certainly Apple’s forte. (The only person on the planet who might dispute this is Microsoft’s CEO, Steve Ballmer.) But more often than not, the real secret sauce is a device’s underlying software. There are plenty of examples of very good software in smartphones such as the Treo (what we use non-stop at our firm) and the BlackBerry. In fact, the BlackBerry is known in corporate circles as “CrackBerries” due to their addictive use, as well as the addicts who refuse to let their Blackberries to be beyond an arms reach. (Again, we can whole heartily relate

given our 24/7 usage of our Treos!) Such devices are usually terrific for a small set of applications, while decent enough for other applications. The BlackBerry and Treo are both great with e-mail. They both are relatively decent cell phones, but are quite lousy at accessing and browsing the Internet.



iPhone is a revolutionary and magical product that is literally five years ahead of any other mobile phone.

Steve Jobs, CEO Apple

The iPhone raises the bar across all applications. It truly is a revolutionary cellphone; Apple's best iPod to-date and the first truly useful web browser device. How did they accomplish so much in a single device? Simple answer; but hard for competitors to copy: cutting-edge software, delivered on very powerful hardware (three microprocessors within the iPhone). At the iPhones' core runs a full version of Mac OS – with first-in-class integration of iPod software and Safari (web browser) software. Elements of the operating software in the BlackBerry Pearl, LG Prada, Motorola Q9, Nokia N95, Sony Ericsson W810i and Treo 750 are certainly robust, but the means to both next-generation application integration and user-experience superiority resides in best-in-class operating systems which is the Mac OS. We would not discount what Jobs said, the iPhone could well be years ahead of its respective competitors.

iPhone Competitive Data, June 18, 2007



Apple
iPhone



Nokia
N95



Samsung
Blackjack



Blackberry
Curve 8300



Palm
Treo 750

Thickness	11.6 mm	21 mm	11.7 mm	15.5 mm	22 mm
Screen Size	3.5 in.	2.6 in.	2.2 in.	2.5 in.	2.5 in.
Display Surface	Glass	Plastic	Plastic	Plastic	Plastic
Wi-Fi	Yes	Yes	No	No	No
Talk Time	8 hours	4 hours	5.5 hours	4 hours	4 hours
Internet Use	6 hours	They Don't Say	They Don't Say	They Don't Say	They Don't Say
Video Playback	7 hours	They Don't Say	They Don't Say	They Don't Say	They Don't Say
Audio Playback	24 hours	They Don't Say	They Don't Say	They Don't Say	They Don't Say

Source: Manufacturers' websites

A few of the iPhone highlights (as described by Apple) include the following:

- Visual Voicemail, an industry first, lets users look at a listing of their voicemails, decide which messages to listen to, then go directly to those messages without listening to the prior messages.
- A 2 megapixel camera and a photo management application that is far beyond any competitive phone today.
- iPhone is a wide-screen iPod with touch controls that lets users “touch” their music by easily scrolling through entire lists of songs, artists, albums and playlists (Cover Flow) with just a flick of a finger. Album artwork is stunningly presented on iPhone’s large 3.5 inch display. When navigating your music library on iPhone, you are automatically switched into Cover Flow by simply rotating iPhone into its landscape position.
- iPhone is a quad-band GSM phone which also features EDGE and Wi-Fi wireless technologies for web browsing and data networking. Users can see any web page

the way it was designed to be seen, and then easily zoom in to expand any section by simply tapping on iPhone's multi-touch display with their finger.

- iPhone also includes Google Maps, featuring Google's groundbreaking maps service and iPhone's amazing maps application, offering the best maps experience by far on any pocket device. Users can view maps, satellite images, traffic information and get directions, all from iPhone's remarkably intuitive and easy-to-use touch interface.
- iPhone employs advanced built-in sensors—an accelerometer, a proximity sensor and an ambient light sensor—that automatically enhance the user experience and extend battery life. iPhone's built-in accelerometer detects when the user has rotated the device from portrait to landscape, then automatically changes the contents of the display accordingly, with users immediately seeing the entire width of a web page, or a photo in its proper landscape aspect ratio. iPhone's built-in proximity sensor detects when you lift iPhone to your ear and immediately turns off the display to save power and prevent inadvertent touches until iPhone is moved away. iPhone's built-in ambient light sensor automatically adjusts the display's brightness to the appropriate level for the current ambient light, thereby enhancing the user experience and saving power at the same time.

While the iPhone's technological capabilities are sure (if not already) to be the envy of product designers of every stripe, the potential economics, *if it is a hit*, of the iPhone will also be the envy of the executive suite of every technology company. So, the question is begged: Will the iPhone be a hit? We will let AT&T's CEO Randall Stephenson answer this question:

...that's great, but what is really intriguing to me is that of the million-plus people who contacted AT&T (about the iPhone), our research shows that nearly 40 percent of them are not AT&T wireless customers today.

Sure, the iPhone will be a hit, but just how large of a success is the pertinent question for shareholders. To answer this query we first look at the state of the iPod ecosystem, then consider the market for cellphones and smartphones.

The iPod was first announced in January 2001. Apple shipped the first iPod on November 10, 2001. By year-end 2001, Apple had sold 125,000 iPods. By June 2003 Apple had sold 1,000,000 iPods. October of 2003 would prove to be a landmark date for the iPod. On October 16, 2003 Apple released both iTunes and the iTunes Music store for U.S.-based PC users. iPod sales surged. Just six months later Apple sold 1,000,000 more iPods. By May that year, sales reached 3,000,000. In July of 2004, the 100,000,000th song was downloaded. By late October of 2004, song downloads would reach 150,000,000 and continue at a rate of 4 million per week. At the end of 2005, Apple had sold nearly 30,000,000 iPods.

Fast forward to today, iPod has captured 85% of the U.S. market. Since 2001, Apple has introduced more than 10 new iPod models, including five generations of the iPod, two generations of iPod mini, two generations of iPod nano and two generations of iPod shuffle. The 100 millionth iPod was sold in April this year and the company continues to sell as much as 10,000,000 iPods every quarter. The iPod has also sparked an unprecedented ecosystem of over 4,000 accessories made specifically for the iPod that range from fashionable cases to speaker systems, and more than 70 percent of 2007 model US automobiles currently offer iPod connectivity. The iTunes Store features the world's largest catalog with over five million songs, 350 television shows and over 400 movies (Disney, Paramount Pictures, Lions Gate and MGM titles). The iTunes Store has sold over 2.5 billion songs, 50 million TV shows and over 1.3 million movies, making it the world's most popular online music, TV and movie store. Apple's iTunes online store has now grown into the third-largest overall music retailer in the United States, leapfrogging ahead of Amazon.com and Target in units sold. iTunes had a 9.8 percent market share in the first quarter of 2007, ranking behind Wal-Mart Stores Inc.'s 15.8 percent and Best Buy Co.'s 13.8 percent, according to The NPD Group - online retailer Amazon.com's share was 6.7 percent, slightly ahead of Target's 6.6 percent.

In terms of mobile music and mobile video, the iPod has such an industry lead that it is not an exaggeration to say "game over," but the iPhone is the best iPod to date. We certainly expect cannibalization of earlier iPod models, but with the new iPod functionality (Cover Flow and 3.5 inch landscape video) of the iPhone, we expect many may purchase the iPhone solely for the new compelling iPod features.





What we're seeing is the beginning of a possible sea change. Apple is educating consumers about what phones can do.

Michael Gartenberg, Jupiter Research

The media hype over the iPhone is reaching a fever pitch with just a few days to launch. But the latest craze in the Wall Street investment community is the apparent one-upmanship on the number of iPhones that analysts are forecasting/guessing that Apple might sell. Some of the recent numbers seem excessively large. They could well be, but we believe that they could be too low. The global cell phone numbers have become daunting and staggering. There are roughly 2 billion mobile phones worldwide. It took 20 years to get the first billion sold. It has taken four years to get the second billion. It looks like it will take just three years to get the third billion. We expect about a billion phones will be sold in 2007 and perhaps +1.1 billion in 2008. This means that approximately half the world's population will have mobile phones by the years 2009 to 2010.

The key question is, "How much market share the iPhone will take?" Even if it is a "small" percentage, the numbers look excessively large. If Apple takes a 1.0% to 1.5% share in 2008, they will sell between 10,000,000 and 15,000,000 phones. Let's assume they sell 10,000,000 in 2008 (10,000,000 being Apple's official forecast; and Apple is unusually conservative in their published forecasts). Assume a conservative price of \$500 per phone. This amounts to a hefty \$5 billion in revenue. Furthermore, assuming an operating margin on the iPhone of 20% to 22% and you are looking at nearly a \$.80 in fiscal 2008 (Sept.) incremental earnings. Don't forget about the subscriber revenue that AT&T (in Apple's exclusive 5-year deal with AT&T) will be sharing with Apple.

Now, the numbers start to get ridiculous...

By calendar year-end of 2009 and assuming a 3.5% global market share take, could Apple have an installed base as much as 50 million iPhones? Sure. (Motorola's wildly successful RAZR phone has sold over 50 million in the past few years and started out at price points of \$499.) If so, and if Apple prospectively shares anywhere from \$5 to \$15 per subscriber on recently published AT&T call/data plans from \$60 to \$100 (per month), then they could be receiving a monthly iPhone per-profit-annuity of anywhere from \$250 million to \$750 million per month - or an annual annuity of \$3.0 billion to \$9 billion! With 900 million shares outstanding (and assuming +90% margins and a 35% tax rate), the "subscriber-annuity" could add incremental earnings of \$2.00 to \$5.50 per share *every year!* To put this in perspective, consensus 2008 earnings estimates is currently \$4.10 per share.

The caveats in this analysis are two-fold. The first, is of course correctly forecasting iPhone annual market share take and subscriber sharing rates. The second is that Apple will be pro-rating iPhone revenues (but not the cash) over a two-year time horizon. But, the point of the above exercise that we would like to convey is that if the iPhone is even reasonably successful (with rolling Canada, Europe and Asia post-2007); it alone could double the size of Apple in a few short years.

Halo Effect = iTunes + iPod + iPhones + Safari + Apple Store = New Mac Customer

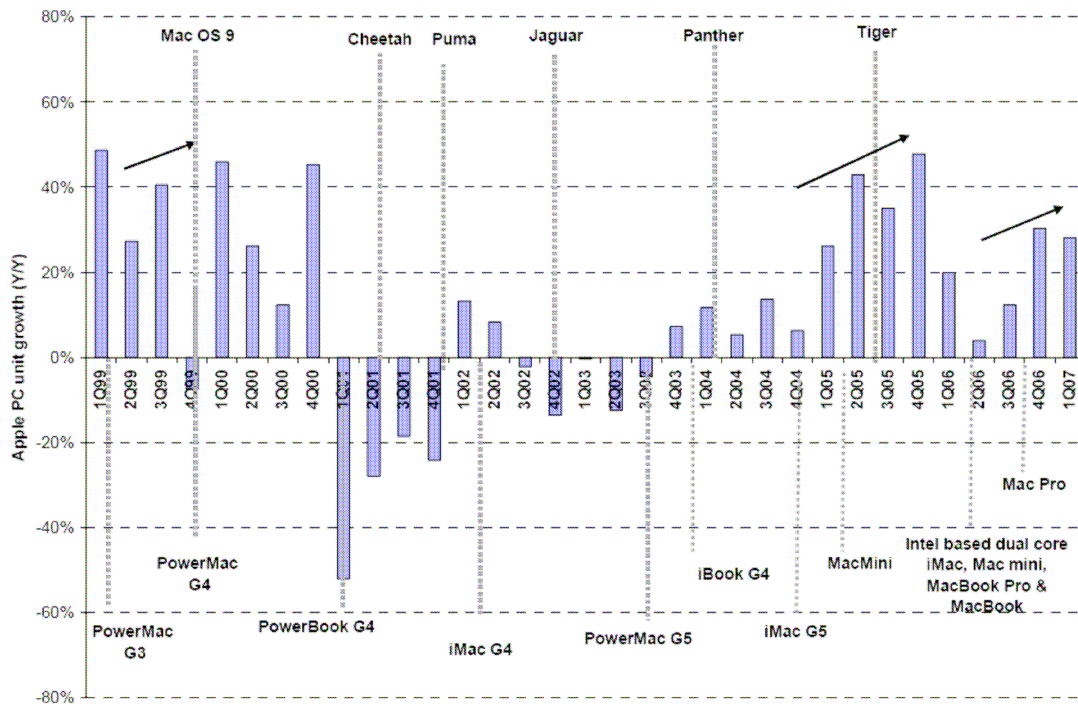
Apple reports that 50% of people buying Macs in their stores are new to the Mac. The oft mentioned Apple "halo effect" is alive and well – and about to get stronger. Apple has a worldwide iTunes installed base of 500 million – the vast majority installed on Windows-based computers – with daily download rates of 1,000,000 copies. With all of the media coverage of iPhone, many missed the significance on June 11 when Apple announced the *free* release of their web browser Safari for Windows (Safari Public Beta 3). iBench reports that Safari is twice as fast as Microsoft's Internet Explorer 7 and up to 1.6 times as fast as Firefox 2. These claims ring true. We have downloaded the free Safari Beta – and it flies (<http://www.apple.com/safari/download/>). Think a few short years out and the significance of the Safari launch on Windows smacks you in the forehead. There are currently almost 20 million Safari users. After the launch of Safari Beta, Apple reported that 1,000,000 copies were downloaded in the first 48 hours. Given our expectation of +50 million iPhone users (recall that the web browser in the iPhone is a fully functional version of Safari) in three years, the cumulative installed base of Safari users could easily reach 100,000,000 by late 2009.

So, why do we think the Apple halo effect will shine ever brighter? When one considers that the combined base of *just* downloaded iTunes and Safari could exceed 750,000,000 in a few years, again, with the vast majority of these users residing inside - *and operating independently* - from Windows operating system-based computers, and the halo effect looks like a Trojan Horse from the vantage point of Gates, Ballmer, Redmond, Washington, et. al. (Such is Steve Jobs genius.)

With so much talk about the iPhone, we would be remiss if we failed to illustrate how prosperous the Mac business line is. Mac products and services represent 55% of the company's total revenue. Mac continues to grow at three times industry growth rates. Mac Notebooks are on fire, growing 79% year-over-year during the March quarter, and growing at five times the rate of Windows-based desktops. (An aside: Our firm has been a dedicated Dell Computer user since over the years, however, because of Boot Camp and the superiority of the Mac, our latest six computer purchases have all been MacBookPros.) Market share take continues unabated – the only hiccup occurring during the first quarter of 2006 while the company's computer line was in the midst of transitioning over to Intel's microprocessor platform.

We expect an acceleration of Mac sales above their current blistering pace after the release of their new Mac OS operating system (Leopard) in October. Leopard promises to be an unusually significant operating system software upgrade – unlike Windows Vista. Leopard will incorporate over 300 new features. Among the most prominent is a feature called Core Animation which may enable an entire new user-interface, windows management (no more overlapping windows; *take that Microsoft*) and applications manager.

Figure 1: Apple CPU growth vs. product releases

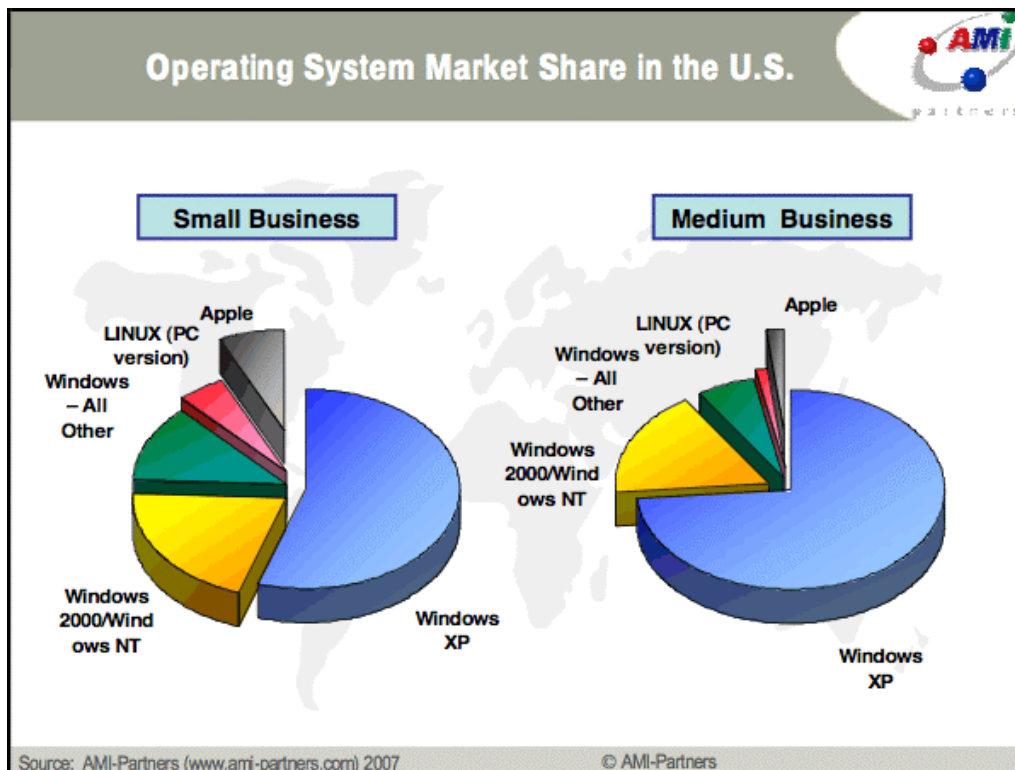


Source: Company data and Deutsche Bank

Apple has had five major OS releases since March 2001. Historically, when Apple has released new versions of their operating system, sales have seen a boost. Priced at \$129, against the current loyal Mac OS user base of 23,000,000, we expect rapid adoption of

Leopard. Tiger (fiscal 3Q-05) has been the company's most successful software product to date. Given all of the improvements, Leopard could experience adoption even greater than Tiger. In its first quarter of shipping Tiger, the company booked overall software sales of \$345 million (64% and 44% quarter-to-quarter), including Tiger revenue – on over 2 million copies of Tiger - of about \$100 million. Furthermore, Tiger sales help spur a 35% increase year-over-year in Mac sales.

Recent research reported from New York City-based AMI Partners indicates more than a doubling of Apple’s share of the hard-to-crack medium business world in the past year. AMI Partners reports that use of Mac desktops in the cubicles of mid-sized businesses has reportedly spiked from 13% to 27% - and has seen a higher-still gain in notebooks, surging from 8% to 18%. AMI has also indicated that smaller businesses have also seen healthy gains for both Apple desktops (7% to 12%) and notebooks (5% to 8%). Huge opportunity remains given that 88% of small businesses and 98% of medium businesses currently use Windows XP-based PCs.



Last, but not certainly least, lets not forget about AppleTV and Apple Stores. We expect more functionality added to Apple TV in the coming months and years, similar to the recently announced YouTube content initiative. The DVD market (\$26 billion) and traditional cable TV service are both ripe for cannibalization by AppleTV.

Apple opened their first store to ringing criticism. Didn't Jobs know that Gateway Computer stores were a flop?

***“Sorry Steve, Here's Why Apple Stores Won't Work”
Business Week wrote with great certainty in 2001.***

"It's desperation time in Cupertino, Calif.," opined TheStreet.com.

"I give [Apple] two years before they're turning out the lights on a very painful and expensive mistake," predicted retail consultant David Goldstein.

Well. Undeterred, Apple forged ahead and opened the first Apple Store in 2001. Today, the company operates 180 stores – including 21 outside of the U.S. Revenues from their stores topped \$850 million during the most recent March quarter. The company's stores are visited by 10,000 customers every week.

The revenue per square foot of an average (non-anchor) retail store is about \$350 per annum. Top-line retailers approach \$600 (Neiman Marcus). Three of the very elite retailers, Best Buy, Borsheims (a Berkshire Hathaway wholly-owned company) and Tiffany's generate \$930, \$889 and \$2,667 per square-foot, respectively. Apple Stores, the deserved envy in all of retailing, generate \$4,100.

Companies that increase sales while expanding margins are a thing of cash-flow beauty. Apple's gross margins and pre-tax margins are 1000 basis points and 800 basis points larger than their respective peers. Apple is gushing cash. When we first bought these shares (2005), the company generated \$2.2 billion in free cash flow. Free cash flow could well approach \$9 billion in fiscal 2009. Cumulative cash on Apple's balance sheet could reach \$35 billion by year-end 2009 (or nearly \$40 per share).

We continue to believe that investors underestimate the company's halo effect, market share take (both computers and smartphones), new market opportunity, significant competitive advantages and barriers and Apple Store operating leverage (180 stores; 10,000 customer visits per week). We expect earnings per share to approach \$4.50 and \$6.00 in fiscal 2008 and 2009, respectively. We continue to be buyers of this stock on any material weakness.

June, 2007

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