WEDGEWOOD VIEW.   ANNUAL REVIEW 2005

APPLE OF OUR EYE

The product is revolutionary.

The product defines cool.

The product bestows hip.

The product, the company and its leader become iconic.

Are we talking about Apple Computer? Sure. If we are talking about Apple Computer, then we must surely be talking about the iPod, right? Nope. Actually, we are describing the Apple II – the first retail personal computer that took the world by storm when it debuted in 1977. Outfitted with a microprocessor speed rated at 1 MHz (microprocessor speeds now cruise along a bit swifter these days at 3 GHz – or 3,000 MHz) and 12 kB of read-only-memory.

The Apple II was more than a marvel; it was nothing short of a technological tour de force. (An aside: The Apple II+ was introduced in 1979. Memory was expanded to a whopping 64kB and the operating system software – called Basic – was a nifty floating point version written by a college dropout at his start-up company named Microsoft.)

Apple Computer's patently loyal users (re: aficionados) can site the companies product genealogy by rote: The Apple II was followed by a long line of grounding computers – Apple III, Apple IIe, numerous iterations of the Macintosh starting in 1984, followed by the Power Macintosh line in 1994, Newton MessagePad, PowerBook, iMac and the iBook.

Apple Computer shareholders can fondly – and not so fondly – recall the amazing booms that invariably soured into gut wrenching busts. Indeed, the journey for long-time Apple investors has been quite the rollercoaster. Surprisingly, the split-adjusted high set in *1983* (Apple III and Apple IIe) of nearly $10 per share was visited as recently as *2003*.

So, why the disconnect between Apple's seemingly two decade-long line of great products and an equally long time frame for frustrated Apple shareholders? In short, Apple Computer, unlike IBM and Microsoft, never licensed its key intellectual property to third party developers and vendors.

Apple's manic control over their in-house hardware, peripherals and world-class operating systems software soon relegated their no-doubt elegant computers into permanent minority market share status. Market share peaked at 23% in 1981, only to fall below 4% in the early 2000's. The "Wintel" alternative of cheaper price points and "good enough" relative functionality catapulted both Microsoft and Intel (and Dell Computer) to near monopoly-sized market shares and profits. With limited market share gains, Apple Computer's operating leverage was constrained largely to new product introductions. Even the company's well-earned product premium price-points could not eradicate their volatile return on capital.

Going forward, the key questions that Apple computer investors need to answer are, "Is Apple Computer circa-2005 different than Apple computer circa-1983 to 2003?" and "Will the iPod's fate mirror that of the fate of the Apple II?"

Our answers to these questions are Yes and No. We make our case as follows…

But first, a review of the amazing iPod (courtesy of iLounge.com)…

In January 2001 Apple introduces iTunes for the Macintosh. iTunes follows the growing digital movement of programs that converts audio CDs into compressed digital audio files, organizes digital music collections, and streams a growing number of Internet radio stations.

By October of 2001, Apple unveils the first iPod equipped with classic Apple differentiating features and functionality that include power, small size factor and the all-important ease of use. The first iPods held 1,000 songs on a 5 GB (gigabyte) hard disk. Early iPods worked exclusively on Macs. Upon the conclusion of 2001, Apple will sell 125,000 iPods.

By the summer of 2002, new versions of iPods would sport more defining features – 10GB and 20 GB hard disk drive models – equipped with a new touch-sensitive scroll wheel. Price points are dropped and iPods now function on Windows based PCs.

Sensing a good thing, in March of 2003, Microsoft announces their "iPod killer" Media2Go audio (and video) player for release Christmas 2003. Media2Go is still M.I.A.

Apple fires back a salvo at Microsoft (and the entire portable music industry) just one month later. The third generation iPod frame is tapered – smaller and thinner, a single touch-sensitive scroll wheel now controls all functions and numerous price points witness a price reduction (30GB iPods are now priced the same as previous 20GB models - $499). Perhaps most significant to widening the burgeoning iPod "moat," the company introduces iTunes Music Store with 200,000 songs along with $.99 songs and $9.99 album downloads. Although the initial launch of iTunes Music Store functions solely with Macs, 1,000,000 songs are downloaded during the first *week* alone.

By June of 2003, 1,000,000 iPods have been sold.

By September of 2003, 10,000,000 songs have been sold. In September 2003, a 40GB/10,000 song iPod is available for $499.

In the first week of January, the new iPod mini is introduced in four colors. The company also announces that 2,000,000 iPods have been sold.

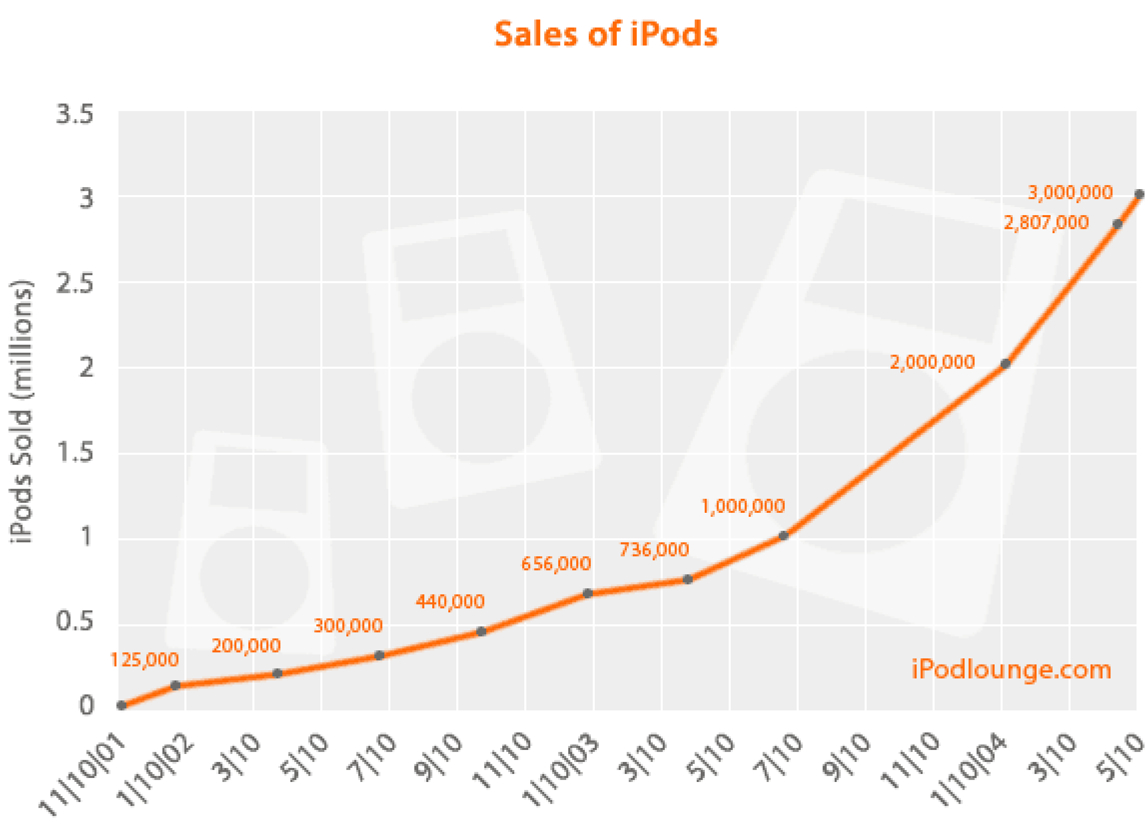
By May of 2004, 3,000,000 iPods have been sold.

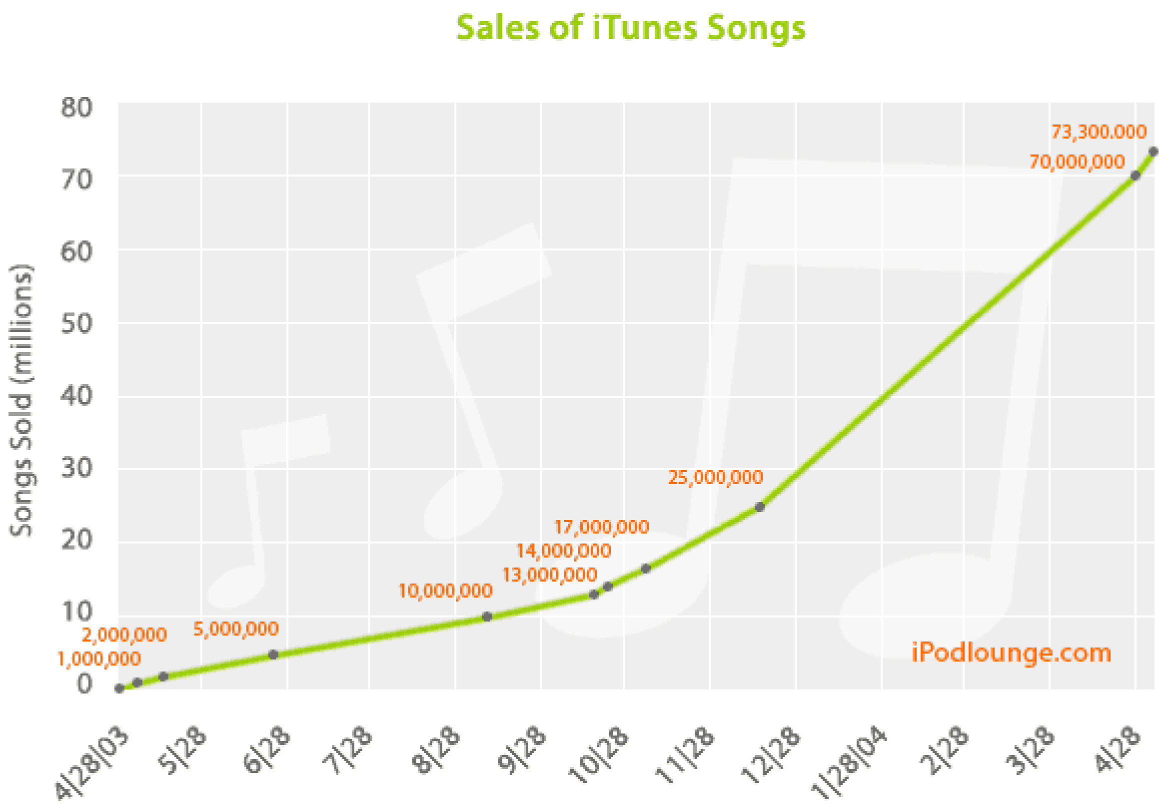
In June of 2004, iTunes Music Store is launched in France, Germany and the UK. One week later 800,000 songs are downloaded.

On July 12, 2004, the 100,000,000th song has been downloaded.

By August 2004, 1,000,000 songs are available on iTunes Music Store.

By October 2004, Apple announces that iPod total mp3 market share is 82% and 92% of all hard-drive competitors. The next closest hard-drive has a 3.7% share. The company also announces that 2,000,000 iPods were sold in just the previous three months and downloads average 4,000,000 per week.





Fast forward twelve months to late 2005 and it is clear that the iPod franchise is as strong as ever.

This September the iPod Nano was introduced and released to critical acclaim. 1,000,000 units were sold in just the first 17 days after its release! By Apple's fiscal year end (2005 September); 22.5 million iPods were sold over the prior twelve months - ***triple*** the amount sold in fiscal 2004.

The "iPod Ecosystem" flourishes on a global scale in over 30,000 storefronts. Over 1,000 third-party vendors now offer iPod accessories. Consumers now demand universal connectivity of their digital data – particularly their music. Businesses continue to innovate to cater to these iPod-unique demands. For instance, 15 automobile manufacturers have announced direct iPod connectivity in factory installed stereos. The company estimates that as many as 30% of all cars sold in 2006 will offer such connectivity. Any takers for a $275 iPod-ready Louis Vuitton purse? (Can you envision the iPod moat getting wider and deeper by the day? We can.)

On to Apple's music division, (iPod and iTunes Music Store) which now generates 40% of total company revenues – up 133% over the year ago quarter. iPods have now shipped at sequentially higher rates 10 quarters in a row. NPD Techworld estimates that iPods account for 75% of all mp3 players now on the market. iTunes Music Store is, by far, the world's leading online music service alone, selling more music in the U.S than some of the top music retailers, including Tower records, Sam Goody and Borders – and has become the second largest online retailer overall after Amazon.com. The iTunes Music Store debuted online in Japan during the most recent fiscal fourth quarter. By quarters end, Apple captured the #1 market share position in Japan. All told, iTunes Music Store operates in 20 countries, with 10 million subscribers and has captured a near unassailable global market share of 85%. Last but not least, Nielson/NetRatings reports that Apple was the fastest growing web property in 2005.

Apple has indicated that they do not expect a slowdown in new/updated iPods during 2006. The iPod story should continue to make headlines this year with company shipment expectations of 75 million iPods – double 2005 sales. Analysts estimate that the company makes about $50 per iPod sold meaning that revenues from iPod sales in 2006 could well approach $4 billion. But in order to achieve this, we expect continued innovation and new iterations for the current lineup of iPods. We also foresee numerous announcements in product advancements and service enhancements for the downloadable video front. Rumored updates for the iPod include a larger screen for the video iPod that would compete with the portable DVR (digital video recorder) now offered by Echostar. iTunes currently offers 16 network shows with more than 300 episodes and iTunes has sold a stunning 3,000,000 video downloads (at $1.99 per download) since the service launched in mid-October.

iTunes now averages daily sales volumes of 1.8 million songs and has cumulative historical sales of 600,000,000 songs!

The bottom line: iPod has become to mp3 players what Kleenex has become to tissue paper.

OK, enough of the iPod craze for a moment. Let's get back to our two key questions…

Again, and more specific, "Is Apple Computer different enough to sustain industry leading growth?" And if so, "Why?"

Our answer: Yes. Apple Computer's sustainable growth, we believe, is a powerful function of a multi-product foundation whose growth is driven by product excellence, ease-of-use adoption and the significant new influx of first-time customers to the Apple product line.

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. At fiscal year 2005, Apple generated operating margins of 12%. For comparison sake, Dell Computer's operating margin was 8.6% and Hewlett Packard's was just 2.8%.

Now, most readers of this Letter are users of numerous types of technology and digital devices. We use our PCs, cell phones, mp3 players, home stereos and laptops enough to know intuitively that the digital world is in the midst of convergence whereby most of our digital devices can connect, communicate and share all forms of digital information. In fact, we as users now demand it.

We believe that the convergence of all devices digital – whether computing or communications based – is not only on a massive scale, but is also an underappreciated (from an investor's point of view) "technological collision" of sorts. In short, product sophistication equals consumer ease of use. Products that fail this so-called "ease-of-use test" are likely to fail in the market place.

Few of us have the time, let alone, the desire to become product specific, digital experts. We want, no, check that - demand that our digital devices seamlessly connect to one another with absolute minimal effort and angst on our part as users.

This is where Apple Computer excels.

Apple customers, whether they be iPod, iBook, iMac, Mac mini, Power Mac, PowerBook or Xserve users know that that all of Apple's products connect and communicate with the "ease of use and adoption" (there is that phraseology again) unlike any other family of products, much less any other combination of independent digital products.

The hub of the company's product integration is the Apple Store. We dare say that the uniqueness of Apple stores has become a "digital Ellis Island" for people just entering the digital world. The company has just 130 stores worldwide, yet they are a marvel of consumer experience. Here is one key Apple store stat to keep in mind – and one that we will monitor closely as long as we are Apple investors – the company reports that *45%* of the customers buying a Mac in their stores are ***new*** to Mac. This stat speaks volumes to us. For Apple Computer to sustain growth, take market share and leverage incremental sales to higher levels of profitability, the company must capture new users. It appears to us that they are doing that in droves!

Store revenue grew 76% from the prior year. Back-to-school store sales of Macs increased 106% year-over-year to 202,000 Mac units. The all-important store barometer of traffic growth continues to shine.

So, what's in "store" for Apple stores in 2006 and beyond?

We believe that Apple Stores are perhaps the most underappreciated element of the so-called, but very real Apple "halo effect" – the effect of single product users becoming multiple product users. Apple's store initiative began earnestly in 2001. The root of this initiative stemmed from too many years of declining market share and at times, lackluster third-party marketing. Apple stores, in prime retail locations, resonate with those of us who are digitally literate and so many of us who are admittedly among the digitally illiterate. Apple store employees are not compensated by product sale commissions. Their mission is to elevate the end-to-end digital experience for Apple customers. As word spreads of the unique (and even exciting) buying experience, traffic should continue to increase.

For calendar year 2005, Apple's 130 stores had over 50 million visitors. Current store traffic flows have increased to nearly 10,000 visitors per week – an increase in weekly traffic of 30% from a year ago. Sales per store are nearly $20 million per annum – a stunning gain, of almost double, from average store sales of $10 million in 2003. The company plans to open as many as 40 stores in 2006. In order to appreciate the magnitude and possibilities of the Apple stores as a very real driver of *unexpected* profits, consider that Best Buy has about 900 stores in just North America. The typical Best Buy store generates about $35 million in revenue per year. A typical Apple store, with significantly less square footage will do about $25 million in revenue this year. How many stores could Apple open before saturating not only the U.S., but global markets? We don't know for sure. But we believe that the model to watch could well be the Starbucks model rather than the Best Buy model. In other words, we believe, at a minimum, that the Apple store model will be much broader than the usual single Apple store in every suburban mall and will encompass numerous strip mall stores and free-standing stores.

In a recent, yet provocative analysis, Pip Coburn, founder of Coburn Ventures and editor of *Waypoints*, postulates that, Apple will have opened 160 stores by 2007 (a very conservative store number, by the way, since the company expects to reach this store number by *2006*) with average sales of $25 million per annum. If even close to the mark, such an assumption of incremental earnings from just the company's store base ($425 million) would easily account for Wall Street's expectation of incremental earnings growth over the next few years.

Lest we forget (amongst the seemingly torrent of iPod news stories), Apple Computer still makes computers – and they can barely make them fast enough. The company shipped 4.5 million Macs in fiscal 2005 – up 38% from last year. The company shipped 1.236 million Macs in the last quarter alone – the second highest quarterly total in the company's history. Mac shipment growth was 48% year-over-year, significantly higher than IDC's most recent published market growth of 13% for the September 2005 quarter. The company shipped 634,000 iBooks and PowerBooks – representing 41% year-over-year growth. As a testament to the superiority of the Mac line, the InfoWorld Test Center Staff recently awarded Mac OS X Tiger the "Best Client Operating System" and Mac OS X Server Tiger the "Best Server Operating System" of 2006. Additionally, the Power Mac G5 Quad earned the title as the "Best Workstation."

On the OS front, Microsoft has released just a single upgrade of their operating system software (Windows XP) over the past five years. Apple has released five upgrades of their

Mac OS. The latest release of Mac OS (i.e., Tiger) last April saw an amazing 16% (2,000,000 copies) of the Mac OS user base upgrade in just six weeks. The company expects 50% of the Mac OS user base to upgrade by this June. In addition to operating system software improvements, application software running on Mac OS has doubled to 12,000 over the past two years. Third party developers have written 6,000 in applications over the past two years as well. As a result, the active user base for Mac OS has doubled to 15 million over the same two years. All told, and from an admittedly small base, Mac OS market share has increased from 3.29% to 4.35% since last December. Clearly, the company is taking market share in desktops and portables.

We expect the company to continue their market share taking ways in 2006, given that for the first time, Apple computers will be outfitted with Intel microprocessors. The transformation from IBM Power PC microprocessors was announced last June. It is scheduled to be completed by 2007 and speculated that the complete transformation could be completed by the end of 2006. The transformation will allow Apple to compete more effectively on price. Performance will also improve via dual and quad core processors. Furthermore, the all-important metric of performance per-watt in portables will improve as well. The models affected are the iMac, 15-inch PowerBook, 13-inch widescreen iBook and the Mac minis.

Apple's lack of a sub-$1,000 notebook has been a major hole in their product lineup given the fact that this is the fastest growing segment in computing. It is believed that Apple will first introduce the earliest Intel-based Macs in the low end laptops (iBooks in the $600-$900 range) at the annual Macworld Expo in early January. This will also coincide with the introduction of the new dual core laptop chips by Intel at the Consumer Electronics show, also in early January.

Rumored Mac lineup changes to be introduced at the Macworld Expo include a new Mac mini reborn as the digital hub centerpiece for the living room. The product, to compete in the evolving "digital living room" with Microsoft and Sony, is expected to have DVR capability, *Front Row 2.0* software (allows iMac users to remotely control songs and videos on their computers) and an iPod dock. Related products include the company's *Airport Express* which streams music from iTunes to your home stereo. Intel's new *Viiv* chip is designed for the management of music, video and photo libraries, as well as tools to handle the Digital Rights Management that content providers demand. (We will watch these developments closely.) In addition, the promise of an integrated, *simple* to use, digital living room has been promised to consumers for some time now, yet consumer satisfaction has been underwhelming to say the least. If Apple can spread their connectivity-ease-of-use magic in our living rooms, they could enter an entire new chapter of growth. Apple LCD TVs and Apple universal remotes could well be the "surprise" products of 2006.

A few final questions: "Have we drunk the Apple flavored Kool-Aid?" Yes we have.

"Do we have concerns?" Of course.

Investing in technology companies is always exciting. But "exciting" investments are usually akin to other "exciting" endeavors such as race car driving and bullfighting – "exciting" rarely means staying in the game very long. Over the years we, have been exceedingly careful in our investments in technology companies. We have tried to select only those rare few that possess businesses with the most defensible business models. Apple's product line will always be subject to intense competitive pressures, as well as technological obsolescence. But Apple's innovation and technological leadership and vision go to the core (no pun intended), of what we consider to be one of the company's most important competitive advantages. The company's legendary "look-and-feel" interfaces are not only a user defined competitive advantage, but the technology that underlies these numerous interfaces is patent protected.

The "Street" expects Apple to earn $1.88 in fiscal 2006. Our investment thesis on Apple is rooted in our belief that the "consensus" does not understand nor appreciate the multiple, self reinforcing drivers of growth at Apple's disposal. We also believe that the company's operating leverage may be under appreciated as well. For instance, for every 1.00% increase in market share taken in the global PC market, the company could tack on an additional .15 to .20 cents to earnings. We expect Apple to earn as much as $2.20 to $2.40 per share in 2006.

With the stock currently trading at $75, the valuation is certainly not cheap at 32X's our 2006 earnings. Even after factoring the cash per share of $10, the shares are valued at a more reasonable 28X's. At current valuations we are only adding partial positions. Actually, we would welcome a pullback in these shares in order to position the company as one of our larger holdings.

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