

MONTHLY TECHNOLOGY COMMENT

Vol. V, Issue #1

January 5, 2005
Peter Labé, CFA

STAYING WITH THE BULLS

In this issue:

- *Resetting the clock for 2005*
- *The Next Big Thing Revisited*
- *Our Top Four Buys*

In our last issue, we wrote essentially what our yearend review, outlook and policy would be. Perhaps it's not surprising we haven't changed very much. But it bears repetition, for emphasis, and we'll do that. We'll review this in a minute.

WHERE HAVE THE STOCKS BEEN?

It is worth noting that in 2004, the year just ended, we had both the market (as measured by the S&P 500) and tech stocks (as measured by the NASDAQ Composite) rise about **9%**, thanks to improved fourth quarter performance (some would say a Bush rally). Within that framework, a considerable portion of our universe outperformed the market, in some cases meaningfully.

Coming off 2003, an up 50% year and up double the market, we don't think 2004 was that bad. We think the 2004 numbers justified our continued bullish posture. Looking ahead, things look good, but we'll come back to that.

Disclosure

I, Peter Labé, certify that (1) the views expressed in this report reflect my personal views on all of the subject companies and securities, and (2) my opinions are not affected by my compensation which is derived solely from brokerage trade commission(s) which may or may not be of securities discussed in this report.

We also note the NASDAQ Composite roughly performed with the general market for the year. This makes a lot of sense, in that in the aggregate, it is harder for IT spending to exceed the general economy today.

LOOKING AHEAD

If we had to pick a consensus view today, for 2005, we think it would be very similar. The psyche of the market is geared to moderate gains, comfortable names, but quite permissive at this point of some deviation. This in turn reflects expectations of something like a 3.6% GDP growth rate, slightly less than 2004. It assumes moderately rising interest rates, the current geopolitical climate, and so on, and so forth. **Should we re-set the clock for the 2005 race on this basis?**

The trouble with the consensus is, it most often does not happen. We think it may err this time, if it does, at least initially, by being too conservative.

The election has been analyzed and re-analyzed. Wouldn't seem there's a lot more ground there. Oil prices and the Iraq situation have received tons of ink. Economic growth, whether there has been enough or not, or whether the sub-sectors have preformed well or as they should, have been written about all over the place. These conflicting themes have been beaten to death, it seems to me. The investor today seems to have a little more **clarity** than he had for much of last year.

We think the market may just say, let's rise above the debate, and let's buy some stock. Basically we think the economy is going to be a little better than people think, even IT spending is going to be a little better. Peer pressure in the equity market is going to be there, if you haven't been in equities the last three months you fell behind the curve.

BAGGAGE THIS CYCLE

This quick overview is not meant to say, no, there is nothing to worry about. Deep down, the **trade imbalance/current account deficit** and the **federal deficit** look to me to be the crosses to bear in this cycle. We don't expect these to go away, – actually, in these accounts, if we manage to just lose a little *less*, it would be viewed as a national triumph and worth points in the market.

Looking at it another way, the equity market can have a reasonable performance as long as these don't get out of control.

BACK TO TECHNOLOGY FOR A MOMENT

For the last few years, as some of our readers may attest, we have been fond of expounding the thesis “there is no Next Big Thing.” The familiar pattern has been:

1960 – 1970	Mainframe
1970 – 1980	Minicomputer
1980 – 1990	Microcomputer (PC)
1990 – 2000	Connectivity (Internet)
2000 –	?

Failure to fill in the blank is a sign of maturity, as are many industry indicia such as IT spending. We had thought wireless was as close as we were going to get in this cycle, and it has done pretty well, but nowhere near the scale to influence this giant industry. The leading candidate remains nanotechnology, from what we can see now. There are a few problems with this. One is that it is a field at least several years away. Another is that so far there are a bunch of little companies with nobody really doing anything. Last, this is not strictly an “electronic” or “digital” development, but is potentially wide spread.

“Maturity” is not the only conclusion we drew from this analysis. Just as important, it suggests that if we can find **superior** growth in the tech field, we are likely to be handsomely rewarded, in part due to scarcity value. Example: the proprietary data storage companies.

FOURTH QUARTER RESULTS AND GUIDANCE

In January and February, we are to be seeing the usual flood of fourth quarter earnings and announcements. Our bet for some time is that the fourth quarter earnings will be good.

The hard part, and the tricky part, is the guidance. Managements are going to tend to be conservative – if too conservative, it could damage the stocks. Right now we think they’ll be “satisfactory” which means more neutral than damaging.

OUR TOP FOUR

Out of our universe, we have selected the top four recommendations for 2005 as follows:

Stock	Current Rating
EMC	Strong Buy
Network Appliance	Buy
Lexmark	Strong Buy
IBM	Buy

EMC and Network Appliance are attractive for growth, Lexmark for a combination of growth with value, and IBM (newly added this month) for value in a favorable part of the cycle.

Our support continues for Gateway on a speculative basis, but we consider this to be a special situation.

2006 ESTIMATES

We are introducing 2006 estimates for most of our universe with this issue, but are **not** calculating P/Es on this basis. These estimates are “opening lines” based on continuation of current business conditions. We also include First Call Consensus where applicable, but caution there are relatively few contributors and the effect of aberrations can be quite large. Of the estimates we carry, details are available for any client with an interest. Anyway, food for thought.

We turn now to our Sector Commentary.

DATA STORAGE

Our lead horses in this market are **EMC (\$14.87 – Strong Buy)** and **Network Appliance (\$33.26 – Buy)**. We have been Buyers of these stocks all through 2003 and 2004, that is to say if readers were to look over the previous twenty-four issues of this publication there would be Buy ratings and write-ups. We continue this policy today. We carry EMC as a Strong Buy, and Network Appliance as a Buy. The leverage on the P/E is different for each stock. The leverage for EMC is on the “E”, while for Net App it is on the “P”. The slight difference in our ratings relates to valuation, not fundamentals.

EMC has considerable room for margin expansion, as we see it, whereas at Net App further margin expansion may be difficult to see, but there is still ample room for investors to increase their appraisal of the company through the multiple.

Both companies have everything: tons of cash, no debt, software differentiation with software approaching half of revenue, and domination in a market that’s growing. This combination is really scarce. They remain at the core of our list for 2005.

SERVERS

These companies don’t fit under an easy single name, perhaps the old “systems company” designation is best after all. We are talking here about Hewlett, IBM and Sun; all huge companies considered mature by most investors. The thing is, from time to time they make money for investors, and they are widely held and very liquid.

Normally we view **IBM (\$98.58 – Buy)** as a holding in a forecast weak equity market, or as a parking place until a better idea comes. However, at this point, we think the investor can make a little money in IBM. We have had three consecutive quarters of \$7 billion orders at IBM Global Services, considered somewhat disappointing with analysts having seen some of those numbers over \$10 in the past couple of years. Our guess is that IBM breaks out of that range. Meantime IBM's hardware offerings look in reasonable shape for this point in the cycle and we would look for some momentum there. We are not too worried about microelectronics or software. Low risk, could get some help from guidance. Changing this stock to a Buy.

Hewlett (\$20.97 – Hold) is another gigantic company where the hardware lines would appear ready if business improves. And it has a nice core printing business. There should be some further upside in this stock but there's too much baggage at this price for us. Dell appears as a competitor in the printing business, and few people we know like the management. Good value, but we think IBM offers us a little more offense.

Sun (\$5.39 – Hold) is another major company that we have been off and on, on and off, within this cycle. It has customer set issues, competitive issues, and a technology issue. At heart, Sun is tied to UNIX, which would seem vulnerable to standards-based computing and commoditization. While true, in real life we have seen these obsolete technologies last in the marketplace for years and years, and then some. Sun is going to recover; it's just hard to judge by how much. Sun has a huge customer base, a lot of which is going to roll with it. The baggage that comes with Sun is also hard to measure. We are drawn to IBM more which is more definable at least and the baggage less heavy.

PC AND RELATED

We consider this area quite fertile for investors, even though the macro field is mature.

For example, we like the printing segment. This sub-industry is very large, grows in double digits (if you are successful), and has very good margins, admittedly through the supplies and not the initial hardware. The big player in this area is Hewlett, with Dell entering the business as a long-term threat/competitor to Hewlett, Hewlett having a 50% market share. The other player is the one we like, **Lexmark International (\$85.00 – Strong Buy)**. Lexmark has roughly a 15% market share and can grow it, but is an OEM supplier to Dell and an ally of Dell, suggesting limited head-to-head competition there. There is lots of cash and no debt; it should be viewed as a growth stock with some tinge of value. We really like this stock here.

Another sector we have liked for years is the graphics space. Visual representation has broad fields yet to conquer, and the technological room for improvement (photographic quality is the bar to be crossed, if ever) is very large. Although we don't rule out Intel, we consider it now as a two horse race between ATI Technologies (\$19.39 – Hold) and **nVidia (\$23.56 – Hold)**. For the next 12 months at least, nVidia appears to be holding all the cards, being early in a new product cycle with a superior product, and where a major coup was scored with a cross-license with Intel, which includes Intel's front side

buses. This now allows nVidia to go after a couple of billion dollar markets it was excluded from before. We took the stock off our Buy list too soon, but we are still inclined to wait for a better opportunity.

Rounding out the sector are the still primarily PC companies, Dell and Gateway.

In this cycle, we have largely (not entirely) not supported **Dell (\$42.14 – Hold)**. This was based on valuation, not so much P/E as market cap for a non-technology company. A good fourth quarter performance brought Dell stock in the realm of a reasonably good investment for 2004. But we still don't like the valuation. At the other end of the spectrum is **Gateway (\$6.01 – Speculative Buy)**, with a new management team and brand new approach – sell through retailers! This is a wild and wooly one, with the e-machines/Gateway combo and Hewlett the team to beat. The stock is still cheap if they can do it – Speculative Buy.

OUTSOURCING

The sad story of Unisys (\$10.18 – Long Term Buy) was related at their analyst meeting on December 7th. The stock is so cheap it won't go down very much, but short term upside is not visible. While the short-term news (low guidance for 2005) is disappointing, we think 2006 could easily see the \$0.91 we carried for 2005 before the downward revisions. At \$10, this is a moneymaking stock if the full year is contemplated.

Guess what, the outlook drawn is so bleak it wouldn't take much to move this stock. This stock could be the **sleeper** of 2005!

On our official rating system, we have moved the stock from Strong Buy to **Long Term Buy** to reflect the new time horizon.

PERFORMANCE AND RATING CHANGES

In December, tech again benefited from an up market. The S&P 500 was up over 3%, and the NASDAQ Composite rose 3.7%. The storage stocks were strong again, with Net App up 10%, EMC up 11%. Both IBM and Hewlett beat the market (4.6%, 4.9%) but Sun gave back some of its recent gains and fell 3%. nVidia continued its strong gains, up 23%, while Dell was up 4% and Lexmark flat. Gateway, strong until recently, fell 12%. The wireless stocks were all down while the outsourcers were mixed. Unisys fell 11%, responding to a change in guidance.

There were two ratings changes this month: IBM from Hold to Buy, and Unisys, from Strong Buy to Long Term Buy. There were downward estimate changes at Unisys and upward changes at nVidia; everything else was minor.

Readers are reminded that our current quarterly and annual estimates are carried on First Call.

REGULATORY COMPLIANCE

Nutmeg Securities, Ltd. has implemented rules that conform to published SEC rules to address analyst conflicts. Accordingly, we note for the record that we have not acted as manager or co-manager for any equity offering, nor received investment banking fees from, any of the companies mentioned in this review. Further, we have footnoted in Table II where the analyst has a position in any of these securities. Next, we have some kind of Buy rating on 6 stocks (32%) but no sell ratings. We consider this somewhat unusual, but not in a case of an attractive investment sector. Finally, we note our investment performance can be gauged by comparing our recommendations which appear in Table I along with the prices at the time, with the NASDAQ Composite Index, which also appears in Table I.

Table I - Price, P/E and Rating

Company (FY)	Symbol	Price		2003A	E.P.S.			P/E		Rating
		12/31/2004	52-week Range		2004E	2005E	2006P	2004E	2005E	
S&P 500*	SPX	1212	1188 1053	\$55.44	\$65.84	\$69.64	\$75.00	18	17	
NASDAQ Composite	COMP	2175	2182 1751							
Storage										
EMC Corp. (Dec)	EMC	14.87	16 - 9	\$0.19	\$0.35	\$0.50	\$0.65	42	30	STRONG BUY
Network Appl. (Apr)	NTAP	33.22	35 - 16	\$0.40	\$0.62	\$0.80	u/r	54	42	BUY
Servers										
Hewlett-Packard (Oct)*	HPQ	20.97	26 - 16	\$1.16	\$1.34	A \$1.70	\$2.00	16	12	HOLD
IBM Corp. (Dec)*	IBM	98.58	100 - 82	\$4.34	\$5.01	\$5.54	\$5.96	20	18	BUY
Sun Micro. (Jun)*	SUNW	5.39	6 - 3	(\$0.24)	\$0.06	\$0.12	\$0.15	NMF	45	HOLD
Personal Computers										
ATI Technologies (Aug.)*	ATYT	19.39	21 - 13	\$0.27	\$0.78	A \$1.06	\$1.28	25	18	HOLD
Dell (Jan fol.)	DELL	42.14	43 - 31	\$1.01	\$1.28	\$1.56	\$1.79	33	27	HOLD
Gateway (Dec)	GTW	6.01	7 - 4	(\$0.96)	(\$0.42)	\$0.25	\$0.40	NMF	24	SPECULATIVE BUY
Lexmark (Dec)	LXK	85.00	98 - 76	\$3.34	\$4.04	\$4.50	\$4.90	21	19	STRONG BUY
nVidia (Jan fol.)	NVDA	23.56	27 - 9	\$0.50	\$0.46	\$0.90	\$1.14	51	26	HOLD
Wireless										
palmOne (May)* ³	PLMO	31.55	47 - 10	(\$0.11)	\$1.72	\$1.94	\$1.95	18	16	HOLD
PalmSource (May)* ³	PSRC	12.74	27 - 12	\$0.10	\$0.39	\$0.60	\$0.60	33	21	HOLD
Res. in Motion (Feb)* ²	RIMM	82.42	104 - 33	\$0.48	\$2.04	\$2.82	\$3.46	40	29	HOLD
Outsourcing										
Celestica Inc. (Dec)*	CLS	14.11	22 - 12	(\$0.11)	\$0.38	\$0.75	\$1.02	37	19	HOLD
Flextronics Intl. (Mar)*	FLEX	13.82	20 - 10	\$0.42	\$0.65	\$0.84	\$1.10	21	16	HOLD
Globix (Sep) ¹	GBXX	3.60	5 - 2	(\$2.00)	u/r	u/r	u/r	N/A	N/A	HOLD
Jabil Circuit (Aug)*	JBL	25.58	32 - 19	\$1.02	\$1.23	\$1.47	\$1.63	21	17	HOLD
Taiwan Semi. Mfg. (Dec)*	TSM	8.49	12 - 7	\$0.30	\$0.58	\$0.50	\$0.56	15	17	HOLD
Unisys (Dec) ⁴	UIS	10.18	16 - 10	\$0.78	\$0.67	\$0.74	\$0.91	15	14	L. T. BUY

Notes: ¹Globix now trading post-bankruptcy. New Symbol GBXX. ²Research in Motion split 2-for-1 on June 4, 2004.

³Palm became palmOne and PalmSource started trading October 29, 2003.

⁴Unisys estimates non-GAAP and exclude pension accounting.

* First Call consensus estimates.

u/r = under review

Source: Nutmeg Securities estimates, except as noted.

Table II - Price History

Company (FY)	12/31/2002	12/31/2003	Prices			12/31/2004	% chg December	2004 year to date
			9/30/2004	10/29/2004	11/30/2004			
S&P 500	879	1112	1115	1130	1174	1212	3.2%	9.0%
NASDAQ Composite	1335	2003	1897	1975	2097	2175	3.7%	8.6%
Storage								
EMC Corp. (Dec) (1)	6.14	12.92	11.54	12.87	13.42	14.87	10.8%	15.1%
Network Appl. (Apr)	10.00	20.44	23.05	24.47	30.16	33.22	10.1%	62.5%
Servers								
Hewlett-Packard (Oct)	17.36	22.97	18.75	18.66	20.00	20.97	4.9%	-8.7%
IBM Corp. (Dec) (1)	77.50	92.68	85.74	89.75	94.24	98.58	4.6%	6.4%
Sun Micro. (Jun)	3.11	4.47	4.04	4.50	5.55	5.39	-2.9%	20.6%
Personal Computers								
ATI Technologies (Aug)	4.65	15.12	15.33	18.05	19.40	19.39	-0.1%	28.2%
Dell (Jan)	26.74	33.98	35.60	35.06	40.52	42.14	4.0%	24.0%
Gateway (Dec)	3.14	4.60	4.95	5.85	6.81	6.01	-11.7%	30.7%
Lexmark (Dec) (1)	60.50	78.64	84.01	83.11	84.90	85.00	0.1%	8.1%
nVidia (Jan)	11.51	23.20	14.52	14.47	19.13	23.56	23.2%	1.6%
Wireless								
palmOne (May)	15.70	11.75	30.44	28.97	35.04	31.55	-10.0%	168.5%
PalmSource (May)		21.77	20.74	22.42	15.84	12.74	-19.6%	-41.5%
Res. in Motion (Feb)	6.56	33.42	76.34	88.20	88.97	82.42	-7.4%	146.7%
Outsourcing								
Celestica Inc. (Dec)	14.10	15.07	12.70	14.48	15.18	14.11	-7.0%	-6.4%
Flextronics Intl. (Mar)	8.19	14.80	13.25	12.05	14.35	13.82	-3.7%	-6.6%
Globix (Sep) (1)(2)		4.00	3.25	2.61	3.05	3.60	18.0%	-10.0%
Jabil Circuit (Aug)	17.92	28.30	23.00	24.31	25.06	25.58	2.1%	-9.6%
Taiwan Semi. Mfg. (Dec)	7.05	10.24	7.14	7.57	7.97	8.49	6.5%	-17.1%
Unisys (Dec)	9.90	14.85	10.32	10.62	11.49	10.18	-11.4%	-31.4%

Palm Had a 20-1 reverse split in October 2002.

Globix stock quoted is post-bankruptcy stock.

Research in Motion split 2-for-1 on June 4, 2004.

Palm became palmOne and PalmSource started trading October 29, 2003.

Notes: (1) The author has a position in the common stock. (2) The author has a position in the debentures.

Source: Reuters.

DEFINITION OF OUR RATING SYSTEM

In general, we have three basic ratings of followed securities: Buy, Sell and Hold (Not Rated is a term we use where a security is not followed, or if followed, where not enough information is currently available to base an opinion).

BUY – is our rating for a stock that we consider currently attractive for purchase for most technology investors. It is a stock that we believe will outperform the market, as measured by the NASDAQ Composite, in a six to eighteen month timeframe. The recommendation could be based on industry or company fundamentals, on equity prices, or any one of a host of other factors, as assessed by the analyst.

We have also formed additional sub-categories of “BUY” rated stocks to make more clear our position. The most common of these are listed below:

- **STRONG BUY** – where the analyst feels a stock is especially attractive, in some cases due to recent price declines, in some where conventional wisdom on prospects is viewed as wrong, in some where there is a visible catalyst that will call attention to the security.
- **LONG-TERM BUY** – where the analyst considers the stock as fundamentally attractive but where fruition appears extended over a longer than normal period of time, or where the stock price currently is higher than levels where the analyst would rate the stock “BUY”.
- **SPECULATIVE BUY** – where the analyst considers the stock as very attractive on the price and the fundamentals but where well above average risk must be assumed by the investor.

HOLD – is our rating for a stock where prospects appear more or less in line with the market, or where we feel a compelling case cannot be made either for Buy or for SELL.

SELL – is our rating for a stock that in our opinion is likely to underperform the market as measured by the NASDAQ Composite in a six to eighteen month time frame.

Additional information on subjects in this report is available upon request.

Our recommendation changes on the securities mentioned in this report are as follow:

ATI Technologies Hold 4/30/04 at \$14.57	Dell Hold 10/31/01 at \$23.89 LT Buy 3/28/02 at \$26.11 Buy 8/9/02 at \$25.59 Hold 11/29/02 at \$28.60	EMC Buy 10/31/01 at \$12.32 Strong Buy 3/28/02 at \$11.92
Celestica Hold 8/30/02 at \$22.97	Gateway Value Buy 10/31/01 at \$5.65 Strong Buy 1/31/02 at \$5.21 Buy 2/28/02 at \$5.60 Strong Buy 3/25/02 at \$6.45 Buy 12/31/02 at \$3.14 Strong Buy 7/31/03 at \$5.11 Buy 4/30/04 at \$4.82 Speculative Buy 9/1/04 at \$4.39	Globix Spec. Buy 10/31/01 at \$0.56 Hold 1/31/02 at \$0.06
Hewlett-Packard Sell 10/31/01 at \$16.83 LT Sell 12/31/02 at \$17.36 Hold 1/8/03 at \$19.65 Buy 5/5/03 at \$16.65 Strong Buy 5/30/03 at \$19.50 Buy 8/2/04 at \$20.15 Hold 9/1/04 at \$17.89	IBM Hold 10/31/01 at \$108.77 Buy 1/5/05 at \$98.58	Jabil Hold 8/30/02 at \$18.71
Lexmark International Hold 1/5/04 at \$78.64 Strong Buy 3/31/04 at \$92.00	Network Appliance Strong Buy 10/31/01 at \$13.30 Buy 9/1/04 at \$20.07	nVidia LT Buy 10/31/01 at \$42.75 Buy 1/31/02 at \$65.74 Strong Buy 2/28/03 at \$52.01 u/r 6/28/02 at \$17.18 Buy 7/25/02 at \$15.07 Strong Buy 8/9/02 at \$9.42 Buy 5/30/03 at \$ 26.17 Strong Buy 6/30/03 at \$22.91 Buy 8/29/03 at \$18.17 Hold 9/30/03 at \$15.91 Strong Buy 1/5/04 at \$23.20 Hold 8/2/04 at \$15.42 Buy 8/9/04 at \$9.43 Hold 10/29/04 at \$14.47
palmOne Sell 10/31/01 at \$48.60 Hold 1/31/02 at \$74.80 Sell 5/31/02 at \$31.80 Hold 8/30/02 at \$15.20	PalmSource u/r 10/31/03 at \$38.17	Res. In Motion Buy 10/31/01 at \$16.01 Strong Buy 2/28/02 at \$23.89 LT Buy 4/15/02 at \$20.39 Hold 2/28/03 at \$12.70
Sun Microsystems Hold/LT Sell 10/31/01 at \$10.17 LT Buy 11/29/02 at \$4.29 Buy 1/8/03 at \$3.75 Hold 9/30/03 at \$3.31 LT Buy 1/5/04 at \$4.47 Hold 4/30/04 at \$3.90	Taiwan Semi Mfg. Hold 8/30/02 at \$8.17	Unisys Value Buy 10/31/01 at \$8.93 Buy 1/31/02 at \$12.50 Strong Buy 8/9/02 at \$7.82 Buy 7/31/03 at \$12.26 Strong Buy 8/29/03 at \$12.98 Buy 10/29/04 at \$10.62 Long Term Buy 1/5/05 at \$10.18

This report has been prepared from original sources and company data that we believe to be reliable, but make no representation as to its accuracy or completeness. This report is published solely for informational purposes and is not to be construed as an offer to sell, a solicitation of an offer to buy any security, or the provision of or an offer to provide investment services in any state where such an offer, solicitation, or provision would be illegal. Any opinions expressed herein are statements of our judgment on this date and are subject to change without notice. Recommendations contained in this report represent a high degree of risk and may not be suitable for all investors. Nutmeg Securities, Ltd., its affiliates, its subsidiaries, and/or its officers and employees may from time to time acquire, hold, or sell a position in the securities mentioned herein. Additional information on subjects in this report is available upon request. Member NASD, SIPC and Chicago Stock Exchange. All rights reserved by Nutmeg Securities, Ltd.