Nutmeg Securities, Ltd. EQUITY RESEARCH

Nutmeg Securities, Ltd., 1960 Bronson Road, Bldg. 2, Fairfield CT 06824 (203) 255-3838 (800) 288-5513 Fax: (203) 255-3069

MONTHLY TECHNOLOGY COMMENT

Vol. VI, Issue #1

January 3, 2006

Peter Labé, CFA

PREPARE FOR A YEAR OF MIXED RESULTS

In this issue:

- *Re-stating the fundamentals*
- *More cautious than before*
- *Is there a standout "stock of the year"?*

THE RECENT TECH RALLY

The fourth quarter tech stock rally looks to be for all the right reasons. The litany for the bullish camp would seem to include:

- economy is performing well
- rising interest rates do not look like they have too much further to go, consensus is perhaps one or two more quarter-point bumps
- stable (though high) energy prices, possibly with some downward movement
- a cooling off of the housing market which had been so strong with low interest rates, but not a recession or major upsetting development
- retail sales should hold up pretty well, while capital spending should improve with tons of corporate cash and continued good business

- inflation is likely to remain modest
- tech earnings so far have come through pretty well

Sounds good. However, we have learned that in these markets it pays to lean against the wind. So, while things still look good, we're moving down one notch of caution.

We have been a **moderate bull** since 2003 (in 2003 we were a **raging bull**) and now turn to a **cautious bull**. We think investment returns of **7-9%** may be too high for 2006 (moderate bull) and **5-7%** may be more realistic.

We come to this view from several lines of thought. One is interest rates. The Fed doesn't have to overshoot, it merely needs to tack on enough quarter points to 5%, which affects most other interest rates, e.g. prime might become 8½%. The effect on the real estate market at this level of rates is unknown; it could, however, be significant. A secondary effect back into consumer credit might be likely. Retail sales have held quite well but could suffer some here.

A second line of thought says General Motors goes bankrupt. We are not experts on this stock and are not predicting any adverse development. The media, however, has been full of these stories and the rating agencies have lowered the company's bonds to "junk" status. If a bankruptcy were to occur, we believe there could be considerable fallout in consumer confidence, retail sales, stock market performance, and so on. This risk might hang over the market for some time.

Third, it is always possible the inflation bears are right, there is more inflation in the economy than we think. The case for this development is fortified by the price of gold, now over **$500 per ounce!**

Last, we note the inverted yield curve, i.e. long-term interest rates are at or below short-term rates. There is some historical precedent for subsequent recessions when this happens, which we cannot tell right now for this cycle. The fact long bonds are down (e.g. 10-year treasuries at 4.39%) suggests little strength in the economy.

The bear case, summed up, is a slowdown in economic growth accompanied (or induced) by rising interest rates.

EXPERIENCE IN 2005

For the year, the overall stock market (measured by the S&P 500) was up 3%, while the NASDAQ Composite was up 1.4%. The NASDAQ Composite fell a little further behind the market than we were expecting, and accordingly performance in our universe was slightly less than we expected. The last three months looked good for NASDAQ, however, and we think the next six months may also reflect better results and investor rotation into this sector.

For 2006 as a whole, we expect another tough market like 2005 and emphasize selectivity and earnings growth in our individual issues.

"STOCK OF THE YEAR"

In the past we have indulged in this speculation, but we might not this year. There are too many candidates! We could go with stocks like Lexmark, Sun, Unisys or Gateway as downtrodden out-of-favor stocks where a case could be made that what we will be looking at next December will be something very different (and presumably higher!). Or we could go with Hewlett and nVidia, as companies that "got it done" in 2005 and give every indication of follow-on in 2006. Last, in-between, is a stock like Dell, a moderate casualty but where a year from now could look much better.

We're not going to pick one this year, but consider the exercise worthwhile in focusing our thinking.

OUR LINEUP ENTERING 2006

EMC and **Network Appliance** did all they could reasonably or humanly be expected to do in 2005, yet both stocks were roughly flat for the year. The trouble was, we think, the multiple. Rising interest rates suppressed the multiple. If so, we think the first half might be pretty dull for the stocks, so for now we reduce them to **Hold.**

In the server group, we continue to rate **Hewlett** and **IBM** as **Strong Buys**. Hewlett is developing a glorious blend of profitable businesses with required cost cuts to open up as the premiere investment in the group. The stock is still attractive here. IBM is just plain too cheap for what they are, and we feel this has to get recognition. We are also moving **Sun Microsystems** from **Sell** to **Hold.** Basically we like the new server products. The "Niagara" server product line offers 5x performance at 1/5 power relative to competitors, albeit appealing to the existing three million Solaris 10 user base primarily. Although UNIX (Solaris) is on a long, slow downward curve this is the kind of thing Sun should be doing while it develops new revenue streams.

In the PC space, we are expecting **Lexmark** to come from miles back in the pack, like Sea Biscuit, and finish close enough to the winner's circle to be a big reward. Also in this space, we have **nVidia**, doing everything right, driving estimates up, and in an exciting arena. We have both rated as **Strong Buy** despite their very dissimilar investment characteristics.

Finally, in Services, we have **Unisys.** After many quarters of showing earnings disappointments of considerable magnitude and every type and description, we see the start of an upcycle by midyear that is certainly not baked in to the stock. Keep as **Strong Buy.**

"STOCK OF THE YEAR" REVISITED

What would it take for some of these stocks to be "Stock of the Year?" In our view, the following:

EMC – another software acquisition, and for earnings to beat consensus by $0.05.
Network Appliance – revenue growth rate to pick up 5 points.
Hewlett-Packard – beat every quarter estimate and raise guidance each time.
IBM – double the percentage dividend payout. Stock buyback has a proven record of doing nothing for the holder, and in fact may be adverse in that it makes it clear the business is not good enough to reinvest in.
Sun – milk the core Solaris business while developing new revenue streams.
Dell – take off when Windows Vista/Office 12 and new micros are introduced late 06, MUST capitalize on this opportunity.
Gateway – same as Dell, must make real money and build healthy balance sheet.
Lexmark – must re-price (lower) on raft of new products to reverse momentum and get supplies growth going again.
nVidia – bump the estimates, make sure a provable case on next generation chips that others are too far behind.
Unisys – prove that this time the "turn" is real.

BASIC BELIEFS – RESTATED

As we start Volume 6 of this monthly, it might be useful to review back where we started with Volume I. These principles are still in effect. Not in any order, and out of memory, they are:

1. There is no "Next Big Thing" in the industry. There is no microprocessor, no minicomputer, and so on. Those waves of growth are behind us. The closest might be wireless, but even so not the same. There is no new driver!
2. IT spending is relatively mature. The rule of thumb used to be it grew at 3x GDP growth, then 2 1/2x, then 2x, and we are probably at 1.5x or even 1.0x. This does NOT mean we can't invest, just the character of the investment has changed. For example, large enterprises tied to IT spending might still be attractive as business cycle plays, or product cycle plays.
3. After 40 years of growth, the computer industry is a very large industry. This means there will always be attractive sectors, attractive specialties, new companies, and so on. There will be money made in companies with the wherewithal to increase their share of the IT spending pot.
4. This stock group might be 15-20% of the market in many indexes, which means it can not be ignored, and there is always some amount of excitement in the technical industries due to change – perhaps the most frequent catalyst for investors to make money.

5. Inflation is **always** a death sentence on performance based on lots of historical precedent.
6. The fact not every one can do well means Selectivity will be important
7. Some businesses that didn't look so good before, in the new environment don't look that bad – e.g. the printer business.
8. Hardware continues to commoditize but great businesses have been built around software functionality packaged with hardware, e.g. the data storage stocks. These horizontal application specialists are prized possessions and the list constantly combed for others.
9. Of the three great subsectors, Hardware, Software, Services, we would have to say Software is the most attractive. Hardware commoditizes a little more each year, services is too people intensive (and right now in oversupply), so software is where the promise of margins really resides.

PERFORMANCE AND RATING CHANGES

There were no important estimates changes this month. Hewlett's annual analyst meeting gave slightly increased guidance. We have made three rating changes this month: we lowered EMC and Network Appliance to Hold, and raised Sun from Sell to Hold. Readers are reminded that our quarterly and annual estimates are shown on First Call.

Performance of the group in December was a little ragged. The NASDAQ Composite was down 1.2%, while the overall market (S&P 500) was flat (down 0.1%). Our universe did not fare so well under these conditions.

In the storage area, EMC was down 1½%, Net App down over 7%. In servers, Hewlett was down 3.5%, IBM down more than 7%, but Sun Micro was up 11%. In PC, nVidia rose 1.1% and Dell was flat at minus 0.7%. Gateway, down 17%, and Lexmark, down 6%, led the decliners. In services, Unisys dropped 5%.

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 5 stocks (31%) and no sell ratings (0%). 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 12/30/2005	52-week Range	E.P.S. 2003A	E.P.S. 2004A		E.P.S. 2005E		E.P.S. 2006P	P/E 2005E	P/E 2006E	Rating
S&P 500*	SPX	1248	1276 1136	$55.44	$67.10		$74.61		$79.93	17	16	
NASDAQ Composite	COMP	2205	2278 1890									
Storage												
EMC Corp. (Dec)	EMC	13.62	15 - 11	$0.19	$0.37		$0.53		$0.65	26	21	HOLD
Network Appl. (Apr)	NTAP	27.00	35 - 23	$0.40	$0.62		$0.78		$0.98	35	28	HOLD
Servers												
Hewlett-Packard (Oct)*	HPQ	28.63	30 - 19	$1.16	$1.34		$1.62	A	$1.82	18	16	STRONG BUY
IBM Corp. (Dec)*	IBM	82.20	99 - 72	$4.34	$4.50	R	$5.16		$5.67	16	14	STRONG BUY
Sun Micro. (Jun)*	SUNW	4.19	6 - 3	($0.24)	$0.01		($0.06)		$0.03	NMF	140	HOLD
Personal Computers												
ATI Technologies (Aug.)*	ATYT	16.99	20 - 10	$0.27	$0.78		$0.07	A	$0.52	243	33	HOLD
Dell (Jan fol.)	DELL	29.95	42 - 28	$1.01	$1.28		$1.53		$1.63	20	18	HOLD
Gateway (Dec)	GTW	2.51	6 - 2	($0.96)	($0.40)		$0.12		$0.19	21	13	HOLD
Lexmark (Dec)	LXK	44.83	87 - 39	$3.34	$4.13		$3.00		$4.00	15	11	STRONG BUY
nVidia (Jan fol.)	NVDA	36.56	39 - 20	$0.50	$0.57		$1.67		$2.25	22	16	STRONG BUY
Wireless												
palmOne (May)*[2]	PALM	31.80	37 - 21	($0.11)	$1.54		$1.61		$1.88	20	17	HOLD
Res. in Motion (Feb)*[1]	RIMM	66.01	85 - 51	$0.48	$2.10		$2.63		$3.31	25	20	HOLD
Services												
Accenture (Aug)*	ACN	28.87	30 - 21	$1.05	$1.23		$1.46	A	$1.52	20	19	HOLD
Affiliated Computer (June)*	ACS	59.18	61 - 46	$2.62	$3.12		$3.41		$3.94	17	15	HOLD
First Data (Dec)*	FDC	43.01	45 - 37	$1.96	$2.16		$2.28		$2.55	19	17	HOLD
Unisys (Dec)[3]	UIS	5.83	10 - 4	$0.78	$0.31		$0.47		$0.67	12	9	STRONG BUY

Notes: [1]Research in Motion split 2-for-1 on June 4, 2004.
[2]Palm became palmOne and PalmSource which started trading October 29, 2003.
[3]Unisys 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)	12/31/2003	12/31/2004	9/30/2005	Prices 10/31/2005	11/30/2005	12/30/2005	% chg December	2005 year to date
S&P 500	1112	1212	1229	1207	1249	1248	-0.1%	3.0%
NASDAQ Composite	2003	2175	2152	2120	2233	2205	-1.2%	1.4%
Storage								
EMC Corp. (Dec)	12.92	14.87	12.94	13.96	13.83	13.62	-1.5%	-8.4%
Network Appl. (Apr)	20.44	33.22	23.74	27.33	29.12	27.00	-7.3%	-18.7%
Servers								
Hewlett-Packard (Oct) (1)	22.97	20.97	29.20	28.04	29.67	28.63	-3.5%	36.5%
IBM Corp. (Dec)(1)	92.68	98.58	80.22	81.88	88.90	82.20	-7.5%	-16.6%
Sun Micro. (Jun)	4.47	5.39	3.93	4.00	3.77	4.19	11.1%	-22.3%
Personal Computers								
ATI Technologies (Aug)	15.12	19.39	13.94	14.46	16.36	16.99	3.9%	-12.4%
Dell (Jan)	33.98	42.14	34.20	31.88	30.15	29.95	-0.7%	-28.9%
Gateway (Dec)	4.60	6.01	2.70	2.85	3.04	2.51	-17.4%	-58.2%
Lexmark (Dec)	78.64	85.00	61.05	41.52	47.62	44.83	-5.9%	-47.3%
nVidia (Jan)	23.20	23.56	34.28	33.55	36.15	36.56	1.1%	55.2%
Wireless								
Palm , Inc. (May)	11.75	31.55	28.33	25.64	28.38	31.80	12.1%	0.8%
Res. in Motion (Feb)	33.42	82.42	68.30	61.49	61.13	66.01	8.0%	-19.9%
Services								
Accenture (Aug)	26.32	27.00	25.46	26.31	28.44	28.87	1.5%	6.9%
Affiliated Computer (June)	54.46	60.19	54.60	54.11	55.78	59.18	6.1%	-1.7%
First Data (Dec)	41.09	42.54	40.00	40.45	43.27	43.01	-0.6%	1.1%
Unisys (Dec)	14.85	10.18	6.64	5.11	6.15	5.83	-5.2%	-42.7%

Palm Had a 20-1 reverse split in October 2002.
Research in Motion split 2-for-1 on June 4, 2004.
Palm became palmOne and PalmSource which 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

Celestica
Hold 8/30/02 at $22.97
Ended coverage 5/2/05 at $11.50

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
Sell on 7/1/05 at $39.46
Hold on 9/1/05 at $35.60

EMC
Buy 10/31/01 at $12.32
Strong Buy 3/28/02 at $11.92
Buy 8/1/05 at $13.69
Hold 1/3/06 at $13.62

Flextronics
Hold 8/30/02 at $9.47
Ended coverage 5/2/05 at $11.15

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
Hold 6/1/05 at $3.46

Globix
Spec. Buy 10/31/01 at $.0.56
Hold 1/31/02 at $0.06
Ended coverage 5/2/05 at $3.55

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
LT Buy 7/1/05 at $23.51
Strong Buy 8/1/05 at $24.62

IBM
Hold 10/31/01 at $108.77
Buy 1/5/05 at $98.58
Strong Buy 5/2/05 at $76.38

Jabil
Hold 8/30/02 at $18.71
Ended coverage 5/2/05 at $27.60

Lexmark International
Hold 1/5/04 at $78.64
Strong Buy 3/31/04 at $92.00
Hold 11/1/05 at $41.52
Strong Buy 12/1/05 at $47.62

Network Appliance
Strong Buy 10/31/01 at $13.30
Buy 9/1/04 at $20.07
Strong Buy 6/1/05 at $28.76
Hold 1/3/06 at $27.00

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
Buy 3/1/05 at $28.99
Strong Buy 4/1/05 at $23.76

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
Acquired 11/14/05 at $18.50

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
Sell 7/1/05 at $3.73
Hold 1/3/06 at $4.19

Taiwan Semi Mfg.
Hold 8/30/02 at $8.17
Ended coverage 5/2/05 at $8.61

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
Buy 6/1/05 at $7.24
Long Term Buy 8/1/05 at $6.47
Strong Buy 11/1/05 at $5.11

Accenture	Affiliated Computer	First Data
Hold 5/2/05 at $21.70	Hold 5/2/05 at $47.67	Hold 5/2/05 at $38.03