"old things pass away and all things become new"

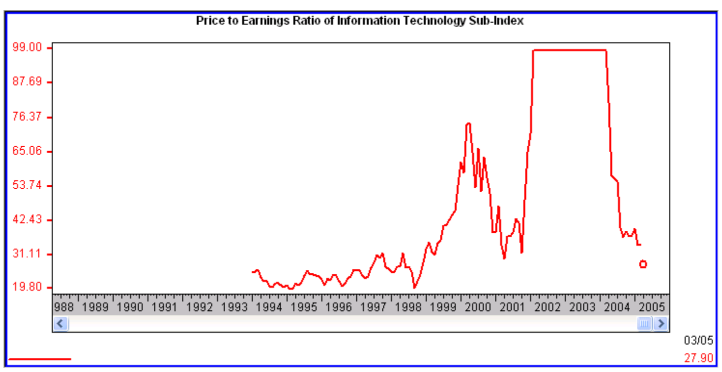
We at Patient Capital Management hope that 2005 is a happy and healthy year and trust that the New Year brings forth much joy.

Even though the NASDAQ peaked more than five years ago and investors lost a tremendous amount of money, technology shares still command premium multiples. We fail to understand why this "technology premium" exists and believe that at some point in the future investors will no longer "pay up" for just about every technology business. As usual we are early; we have held this view for the past five years!

While technology shares are trading far below their 2000 highs they are still trading at premium multiples. As the graphs below illustrate, the P/E of the technology index is still very high at 27.90x and is approximately forty per cent higher than the broader market index. While both ratios are considerably below their all time highs they are still excessive on an absolute basis.

Graph 1

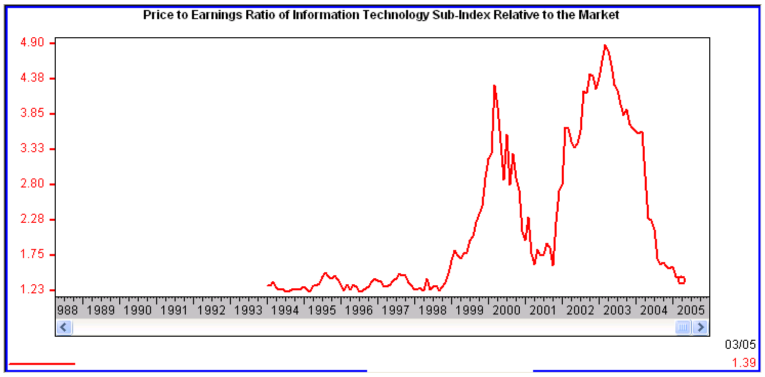
Price to Earnings Ratio of Technology Sub-Index Relative [1]



[1] Graphs Courtesy of C.P.M.S.

Graph 2

Price to Earnings Ratio of the Technology Sub-Index Relative to the Market



Technological advances have been exciting and tempting investors since the 1800's. The first "tech mania" occurred in the 1850's with the advent of the steam engine and railroads. Investors during that time bid up the share prices of railroad companies to incredible levels on the expectation that rail travel would revolutionize the world. Since then this pattern of market enthusiasm for new advances has been repeated on several occasions. The invention of the telephone, automobile, radio and television were some of the early twentieth century advances that drove investors into frenzies.

Over the past twenty-five years advances in chip technology, biotechnology and the Internet have had a dramatic effect on the quality of our lives and in the way we conduct business. Investors have also responded in the same fervent way as in the past. Technology shares have once again been bid up to very expensive levels. Today's poster boy for extreme overvaluation is Google. This leading internet search firm is trading at approximately 145x earnings and is worth more than fifty five billion dollars!

A review of past technological innovations reveals similar patterns of economic and financial developments. As new technology is introduced innovators, consumers and investors correctly assess that the new technology will dramatically change the market for its products and/or the manner in which business is conducted. The potential for profit, growth and economic advantage to those businesses that embrace the technology <u>seems</u> boundless. This promise of extraordinary growth and profit has three important implications. Firstly, an investment boom in the new technology takes place. Everybody wants to "get in on the action." Secondly entrepreneurs and

competitors aggressively enter the market. For example, five years after Alexander Graham Bell invented the telephone twenty-thousand telephone companies sprung up in North America! Finally, spin off industries sprout up as the new advances are applied to related businesses.

The economic activity or cycle described above has serious consequences for long-term profitability and returns. Not every innovator reaps the benefits of being first to market. Often the followers win because they learn from the leader's mistakes and/or improve on the product. For example, IBM was the early leader in the personal computer. However, it was eventually overtaken by its competitors; most notably Dell Computers. In addition, extraordinary profits that may have existed get driven down as a flurry of new market entrants and competitors introduce competing products. Amazon.com, the very popular internet retailer recently reported disappointing results in part due to increasing competitive pressures. As well, additional and poorly thought out investment (malinvestment) occurs. Euphoria over the opportunity and perceived growth potential leads to excess investment by existing market participants and new entrants. All of this malinvestment leads to underutilized capacity, which in turn leads to reduced profitability. Investments in fiber optics to carry the anticipated growth internet use were made to point where only two per cent of the fiber optic's capacity was being used! Ultimately as in all industries and in virtually every cycle returns are driven down to more normal levels.

Present investors in shares of technology companies implicitly believe that it's different this time. Today's premium valuations imply that historical economic relationships have changed. Indeed they believe that above average growth and high returns will continue for many years into the future.

The facts are quite different. The following two points reflect the underlying economic reality for a large number of technology businesses:

> **Top line revenue growth is muted. Many companies are now revisiting their expenditures on information technology. Managers are now demanding a return on technology investments. The latest gadgets and computer wizardry don't increase productivity. We can**

actually do more with less. Indeed Michael Dell of Dell Computers states: "… we can commoditize IT services…" [2]

Profit growth has been decelerating. Most of the improvement in profitability has come from cost cutting. Profit growth through expense reduction is unsustainable. In addition, future income will be reduced as new rules for expensing employee stock option grants are adopted later this year.

The above economic conditions suggest that tech firms are not likely to experience high growth and profitability any time soon. Thus in our view the premium multiples accorded to high tech companies are not justified. Investors are very likely to experience very poor returns over the long term.

At PCM we focus on purchasing shares of businesses at a discount to their intrinsic value. We would be very reluctant to purchase shares at a premium for any business; particularly for those businesses confronting the many challenges that today's technology company's face. We also focus on the preservation of capital. In our view, investing in slowing businesses at a premium valuation is a sure way to lose money. Unlike the exciting and appealing "stories" that technology companies and their products offer our story is simple and predictable. Unlike most investments in technology businesses our approach is profitable!

Gary Sharpe
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