BARTON
INVESTMENT MANAGEMENT

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On Thanksgiving;

Can Short-Term Tax Turkeys Cause Long-Term Indigestion?

I hope that you and your family enjoyed a wonderful Thanksgiving holiday. I have much to be thankful for this year including a wonderful family and a great group of clients who have enabled the creation of Barton Investment Management. My only small struggle is that I have to vanquish my writer's block that makes these letters too infrequent.

In the spirit of Thanksgiving, I give thanks for my newly realized freedom to write about specific stocks. In my prior business affiliations, I was drastically proscribed from writing about my individual stock ideas. Justifiably, all of my prior employers were nervous about their employees writing any analyses of specific stocks. If a stock was followed by an in-house analyst, my firm required me to strictly agree with the analyst's opinion. If a stock was not under coverage by my firm, they certainly didn't want to have a rogue opinion coming from an employee outside of the Research Department. More recently, the misdeeds of various analysts in the late 1990's led to a further legal crackdown engendered by the very expensive monetary damages paid by Wall Street to atone for their sins. So, as the CEO of this new advisory firm, I give thanks for the freedom to express my specific stock thoughts in these letters.

Besides Thanksgiving, it is also the time of year when everyone wants to reduce their potential tax liabilities by realizing tax losses. So, even though it is no fun, I want to write my current thoughts on those stocks that I have recommended that have performed poorly year-to-date. In general, I want to caution all of my clients that the end of the year is very often the wrong time to realize tax losses because many stocks are artificially low due to tax selling by others. Don't overemphasize tax losses to the exclusion of holding on to potentially rewarding investments. With that thought in mind, let's take a look at three stocks that are both significant holdings of our clients (and me!), and have done poorly so far in 2006. Let's analyze *"Jay's Turkeys!"*

The Trex Company (TWP, 11-27 closing price: $22.21, down (-21%) ytd)

Trex is the leading manufacturer of composite (non-lumber) decking products. My original thesis for investing in this company was that Trex had created an alternative decking product that would realize a high secular rate of growth as consumers came to realize the significant maintenance savings from using a wood polymer composite versus traditional lumber in outdoor settings. This thesis was certainly true over the five year period ending in 2005 when sales grew at a compound rate of 20.1%. However, Trex's net earnings actually fell over the same five year period due to what I (and many other published analysts) thought to be non-recurring circumstances.

Trex is probably my leading turkey for 2006. In early November, the company reported its 3rd quarter results and surprised all of its proponents by disclosing that its sales growth had slowed markedly. Yes, we all knew that new housing starts were declining significantly, but we thought that because Trex's product is primarily sold to existing homeowners seeking to improve their homes, their sales volume would continue to grow. Unfortunately, Trex's 2006 revenues are now expected to grow at the relatively slow rate of approximately 10%. So, the secular growth hypothesis for composite decking materials has been affected by the cyclical decline in housing.

The question remains can Trex resume its secular growth in revenues in the years ahead, or will its sales grow at a slower rate in the longer term? I believe that this company has made many improvements over the past year that have been obscured by the slowdown in its sales. I believe that there remains a significant secular sales growth potential for composite decking products. I am reassured by the fact that Trex's management and insiders still own more than 20% of the company. Most importantly, the current stock price is very cheap on a price to sales basis (since Trex is a manufacturing company, its operating leverage is significant and using a price to earnings ratio can be misleading at relative earnings peaks and valleys). Over the past five years, Trex's price to sales ratio has ranged from a high of 3.3x to its current low of 1.1x. Based solely on this valuation range, one could assert that Trex's stock price might double in the future. So, with apologies for being wrong in 2006, I would resist selling Trex's stock merely to realize a tax loss.

eBay, Inc. (EBAY, 11-27 closing price: $32.02, down (-25%) ytd)

You remember eBay. In the fickle world of short-term 'buzz', eBay has been evicted from the penthouse and sent to the basement. It was the darling of the Internet stocks until that 'G' company stole all the headlines. The original eBay online auction business has grown so large that it is now generating 'only' 22% revenue growth on its current annualized revenue base of more than $4 billion. Globally, the PayPal online-payments segment is growing its $1.3 billion revenue base at a still rapid 40% rate. The recent Skype VOIP (voice over Internet protocol) business is adding users at the amazing rate of 250,000 per day! However, if all you looked at was it's stock price, you might think that eBay was an airline company or an auto manufacturer.

eBay really isn't a tax-sale candidate for most of my clients because we started buying the stock before 2006 at prices well below its current last sale (in full disclosure, my clients and I bought this stock in a range of $39 to $25 so far this year). But, the stock qualifies as a 2006 'turkey' because its price has declined significantly in a year that the overall market is up more than 12%.

eBay has suffered from three significant accusations this year. First, they raised the price per listing within their online "Stores" service. This increase was pilloried in the press as injurious to a lot of their smaller customers. In truth, eBay had erred in under pricing this service to the detriment of their core auction listings service. Second, PayPal was hit with the announcement that the 'G' company was going to offer a competing payment service. Rather than putting PayPal out of business, PayPal's current results show little if any loss of momentum. Finally, the 2005 acquisition of Skype has been criticized as overpriced. However, Skype's remarkably rapid growth means that they currently have more than 136 million registered users. All of eBay's segments are beneficiaries of the network effect wherein every additional user increases the value of the network for all users. If this remains true, Skype may yet prove to be a bargain.

The stock market is obviously having a very difficult time figuring out how to value eBay. One hint of this difficulty is that eBay's earnings per share under GAAP (generally accepted accounting principles) will be down this year! This anomaly is caused by the required expensing of stock options grants beginning in January 2006. If you want to find a more meaningful comparison, eBay's cash flow per share is expected to rise 30% this year. EBay's reported earnings are being justifiably reduced by options expensing, however eBay's earnings are not showing the network effects mentioned above. When you are building a new business on the Internet (like PayPal, Skype or eBay China) all of the expenses to add customers reduce reported net income. In truth, many of these expenses are capital expenditures as long as the network effect is real. I suggest that eBay is quite undervalued at a price to current cash flow ratio of 22.4x (versus the overall market at 15.4x). If you have a tax loss in your eBay holding, don't sell! Just buy more and, by this time next year, I believe you will have a gain on both your high cost holdings and your more recent purchases.

Qualcomm, Inc. (QCOM, 11-27 closing price: $36.34, down (-19%) ytd)

Qualcomm is the visionary company that has persisted for almost twenty years in asserting that its CDMA technology is the most efficient means of wireless communication. In the early years of cell phones, all that mattered was voice. And, for more than fifteen years, the world has had two capable and mutually exclusive standards of wireless voice communication, CDMA and GSM - the European-based standard. In more recent years, though, the world of wireless communications has begun to expand to include data and video. These two newer forms of wireless communication require a more efficient 'pipe' to handle the significantly larger flows of the 'bits' that comprise digital data and video. Finally, after all these years, the wireless world has come to agree that generic CDMA is, indeed, the fundamental building block for wireless data and video transmission.

However, there is one problem; the world's wireless equipment manufacturers don't really like paying Qualcomm its royalty rate of approximately 4.3% of the sale proceeds of any CDMA-enabled device. These manufacturers, led by the largest and most strident defender of the European GSM hegemony, Nokia Corporation, assert that CDMA is a nice technology but that they should be allowed to pay a more reasonable rate. So, in the past year, Nokia has asserted that they will not pay Qualcomm any royalties once their license expires in April 2007. In addition, Nokia and five other important equipment manufacturers have appealed to the European Union to find that Qualcomm's royalty rate is 'unfair'. Finally, the governments of both India and China, on behalf of their telecommunications companies, have continued to press Qualcomm for reduced royalty rates in their markets because of their enormous size.

All of these legal and political pressures have caused Qualcomm's stock to decline in a year when their revenues and earnings have shown wonderful growth. Qualcomm's cash flow (I am using cash flow rather that GAAP earnings to avoid the distortion caused by the adoption of options expensing in January 2006) growth for fiscal 2006 exceeded 40%! I believe that Qualcomm is an enlightened and fair monopolist, licensing its critical intellectual property portfolio to all clients at a reasonable 4% rate. I expect all of the dissident parties to ultimately pay a royalty rate for Qualcomm's huge patent portfolio that is very close to 4%. In 1999, the European manufacturers first agreed to pay royalties to Qualcomm. In the next year, Qualcomm's stock appreciated dramatically. I assert that the likely settlement of some or all of Qualcomm's legal battles will cause its stock to appreciate quite nicely in the year to come. This stock isn't a turkey!

> [*Now, for all you lawyers out there, please realize that I personally own meaningful positions in all three of these stocks for my family, my clients and myself. Therefore, in spite of my best efforts to be truthful, you should assume that everything that I have written in this letter is biased and conflicted.*]

Now that we've gotten the legal stuff out of the way, thank you for all of your support over the past year. I apologize, once again, for all the turmoil in my own career that has, in turn, caused you and all of my clients a great deal of stress in 2006. I hereby swear that I will not change affiliations in any way in 2007! Peace.