



Note From  
Edward  
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In general, this summer has been kind to equity investors. As of August 31st, the S&P 500 was up nearly 16% since January 1, and up 32% from what appears to have been the bottom on October 9, 2002. The question now is where will the market go from here.

Several factors give us reason to be optimistic about the future. The economy is operating in an environment of record low interest rates, and the Federal Reserve appears to be determined to keep them from rising until the economy is on a stronger footing. Second-quarter earnings averaged a healthy 9% increase, and year-over-year earnings expectations for the third, fourth and first quarter of 2004 are projected at 13%, 21% and 12%, respectively.

Another positive is that we have begun to see the first steps toward increased capital spending. Against this background, we believe that the economy will continue to rebound, but that the recovery is unlikely to be strong across the board, as it was in the early 1990s. Certain sectors of the economy will flourish while others will continue to underperform. Investors who are prepared to identify market segments with high potential and select stocks based on thorough and diligent research are likely to be rewarded.

An example of a segment we believe will do well is integrated circuit power conversion. In this issue, our head of Research, Ray Rund, explains why this segment will flourish. This issue also includes an interview with the CEO of Power Integrations, a leading supplier of power conversion chips. ■



Semiconductor Industry –  
Growing again, but more slowly ...

Raymond Rund, Managing Director / Head of Research

The Semiconductor Industry historically has been a growth cyclical industry, in that it has shown strong growth over the long term, but also has years in which sales declined. For three decades the industry enjoyed compounded annual growth of over 16%, but year-over-year growth has always been quite variable, and this variability accelerated in the 1990s. After reaching total sales of \$204.4 billion in 2000, an all-time high, industry revenues fell 32% in 2001. So far, the recovery has been slow. The industry grew 1.3% in 2002 and is tracking for growth of 8-10% in 2003.

The key question for growth investors is, "What now?" Will the industry return to its long-term growth rate of 16%, grow at a slower rate, or become a purely cyclical industry?

From the mid 1960s on, demand for computers fueled the industry's growth — first in mainframes, then minicomputers, and finally personal computers and servers. In the mid 1990s, communications contributed significant growth as enterprise, telecom and Internet networks were built, and cellular phones penetrated world markets. The peak industry sales in 2000 were the result of strong Y2K demand for PCs, overbuilding of the Internet and telecom networks, digital cell phone penetration into Asia and the Americas, and massive inventory accumulation in the supply chain.

The industry in 2003 presents a very different situation. Excess inventories at OEMs and contract manufacturers are largely gone. Communications infrastructure is a much smaller part of the demand equation. PCs and cellular handset units are growing again, but more slowly than the 20% and higher growth rates seen in the 1990s. Autos, appliances and digital consumer products have become significant users of semiconductors. These applications are growing rapidly due to unit growth of DVD players, digital cameras, other devices and increasing semiconductor content in cars and appliances.

For the immediate future, semiconductor industry growth will be more closely tied to overall worldwide GDP growth than in the past. However, there are selected segments within the semiconductor industry that appear to be well positioned to enjoy better than baseline growth. Our in-house research has identified three industry segments that are experiencing such growth: programmable logic, digital entertainment, and power management.

For example, there is a growing need for power management circuits to change alternating current (AC) to direct current (DC), and precisely regulate the output voltages and currents. Electric power enters homes and factories as AC at 120 or 220 volts, while electronic devices need DC at 1 to 10 volts. Circuits manufactured using the most advanced semiconductor processes, such as Pentium 4 microprocessors and graphics chips used in PCs and game players require high currents (as much as 10 amperes) at very low voltages (around 1 volt). Indeed, every new generation of microprocessor needs more current at even lower voltages. Supplying high current at low voltage in an efficient, "low noise" environment has become a serious engineering challenge.

In 2002, power management revenues grew over 22% versus total industry growth of 1.3%. Three companies that are leaders in power management applications are Power Integrations (POWI), Intersil (ISIL) and International Rectifier (IRF). In 2002, these companies each expanded their power management businesses by 18-22%. Each one is growing gross margins and is starting to see operating leverage on expanding revenues. All three companies are represented in our model portfolio. We expect these trends to continue through 2003 and into 2004. (An expanded view of Power Integrations can be found in the interview with their CEO in this newsletter). ■

## PORTFOLIO AT-A-GLANCE

As of August 31, 2003

### TOP 10 HOLDINGS

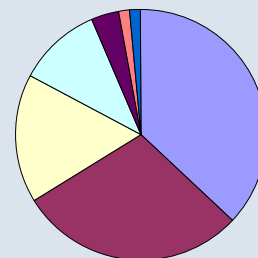
Caremark Rx Inc.  
Eclipsys Corp.  
Fair Isaac  
International Rectifier  
Intersil Corp. - CL A  
Invitrogen Corp.  
Microchip Technology  
Qiagen, N.V.  
Royal Caribbean Cruises  
Xilinx Inc.

### AVERAGE PORTFOLIO CHARACTERISTICS

Number of Holdings	35
Wtd Forward P/E	25.2
Wtd Sustainable Growth Rate	27%
Median Market Cap	2.9 bil
Med Price	
Book Value	2.7

### SECTOR WEIGHTINGS\*

Technology	36.9%
Healthcare	29.2%
Consumer Discret	16.7%
Financial Services	10.9%
Producer Durables	3.5%
Materials & Process	1.5%
Other Energy	1.3%



\*based on sector definitions by Frank Russell Co.



# Executive Insights

Balu Balakrishnan, President & CEO  
Power Integrations [NASDAQ: POWI]

**Q:** *Power Integrations recently was chosen as one of the top 20 sustainable businesses by SustainableBusiness.com. What criteria earned you this recognition?*

**A:** Power Integrations had to meet three primary criteria to qualify for this award. These included continued strong financial performance, a favorable record of employee and community relations, and products that are sustainable from an environmental perspective. We were especially pleased that our power conversion chips were recognized for their environmental efficacy, inasmuch as we have made a point of designing them to reduce both energy consumption and pollution. We also were honored to be the only Silicon Valley company to make the top 20 list.

**Q:** *Power Integrations' IPO was in 1997. Has going public impacted how you run the business?*

**A:** The fact that we are now answerable to analysts and shareholders has prompted us to become more diligent, in terms of reviewing the company's overall performance on a quarterly basis, including spending levels, customer satisfaction, and R&D progress. Some companies contend that Wall Street is too shortsighted and should not demand quarterly results, but we believe that this practice provides a useful discipline for management and greater transparency for investors.

**Q:** *What is your share of the power conversion market?*

**A:** Currently, nearly 92% of the market is comprised of older technology. Power Integrations owns 7% of the market. The other 1% is divided among five other companies that, like Power Integrations, represent the "new technology" of employing integrated circuits for power conversion applications. Clearly, our goal is to replace older technologies by integrating multiple electronic components into more efficient, single chip solutions.

**Q:** *Why does Power Integrations expect to continue to replace older technologies?*

**A:** There are three key reasons. First, in developed countries, energy efficiency is becoming a pressing issue for governments and, consequently, energy efficiency requirements are becoming more stringent. In the U.S., for example, the fact that approximately 10% of household energy on average is consumed while appliances are turned off has not gone unnoticed by the government. This compels manufacturers to make existing, old technology more energy efficient, but over time that becomes an increasingly expensive proposition. Second, smaller and lighter power conversion chips allow manufacturers to produce smaller and lighter appliances, which are more attractive to consumers. Third, our chips are adaptable to the many standards of voltage used around the world, and old technology isn't.

**Q:** *With all these advantages, why does 92% of the market still belong to older technology?*

**A:** The high costs associated with redesigning power supplies constrain manufacturers from developing new models on a regular basis. Much of this cost is driven by the lengthy approval procedures required by the FCC and UL in the United States, and by equivalent agencies in virtually every other country. The ability of Power Integrations to provide smaller, lighter and more energy efficient technologies may not be a sufficient enough reason for a manufacturer to take an existing, old technology power supply off the market. However, energy efficiency requirements are forcing manufacturers to redesign power supplies, giving us more opportunities to replace older technologies. This will help our growth rate going forward.

**Q:** *Why is your market share so much larger versus your "new tech" competitors?*

**A:** Our technology is our greatest competitive advantage. Power Integrations currently has 70 U.S. and 58 foreign patents, including 41 patents granted during the last 18 months.

Some of these patents are for very fundamental technology. This continues to keep our competitors at bay, and makes it difficult for them to match our capabilities.

**Q:** *What do you see as your biggest challenge?*

**A:** Now that we have such a large technology lead over our competitors, our major challenge is to leverage this technological superiority by accelerating our market penetration. For this reason, sales, marketing and applications engineering have become a top priority, and are demanding a greater share of our attention and resources.

**Q:** *What kind of growth are you looking for in the next five years?*

**A:** Our target is to double our market share to 14% in the next five years. That will be in a growing market, so we would expect to be three times our current size.

**Q:** *Do you expect your growth to be totally organic, or are you looking for acquisition opportunities?*

**A:** We have yet to see any interesting acquisition candidates, nor does there appear to be any on the horizon.

**Q:** *Globally, where is your greatest growth?*

**A:** Currently, nearly 80% to 85% of our revenues come from Asia, and in five years we expect that percentage to jump to over 90%. However, those numbers in and of themselves can be misleading, since a significant portion of the chips we manufacture in Asia are then shipped to U.S. and European markets. Within five years, we also will move much of our testing facilities to Asia.

**Q:** *Where do you see your strongest growth, from a product standpoint?*

**A:** Our most robust growth currently is in supplying chips to DVD players and LCD monitor manufacturers. Last year, we also introduced an electronic solution for the telecommunication and networking markets, and this product has already attracted significant interest. Going forward, we expect that Internet Protocol phones that receive and transmit calls via the Internet may become our fastest growing market for this new product. ☒



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