Van Dien Asset Management LLC
First Quarter 2011 Update

In our January update, we expressed some caution due to the market's recent strength and our sense that some degree of investor complacency had developed. Who knew that we would experience two "Black Swan" – type events within the same quarter? These events, the civil protests and resultant instability across the Middle East and the earthquake-tsunami disaster in Japan, generated great angst and selling pressure within the markets. The initial Black Swan, the conflicts and uncertainty across the Middle East, caused crude oil prices to shoot up dramatically. The spot price for West Texas Intermediate Crude increased 24% in ten days, before stabilizing in the $100-$105 per barrel range. In the last week oil prices have begun to creep up again, breaking through this range. However, the initial shock of higher oil prices, and fear that they might curtail the fragile economic recovery, appears to have subsided.

As the market wrestled with the daily news flow from the Middle East and its ramifications, Japan experienced the horrific tsunami disaster and the ensuing radiation leak at the Fukushima Daiichi nuclear power plant. While analysts tried to assess the damage to Japan's infrastructure and the global economy, investors further abandoned equities in a flight to safety. These two events (Middle East instability and Japan disaster) together caused the NASDAQ Composite and the S&P 500 to sell off 7.7% and 6.4%, respectively, between February 22 and March 16. However, as authorities began to make progress on the radiation leak and worst-case scenarios appeared increasingly remote and fully discounted in stock prices, a funny thing happened. Equities began to rise. In fact, during the final eleven days of the first quarter, the NASDAQ Composite increased nine of them, and the US equity market regained almost all that it had lost in the previous weeks. Worrisome rhetoric regarding the extent of the damage to the electronics supply chain took a backseat to discussions of the long-term stimulative nature of rebuilding Japan.

While the uncertainty in the Middle East and the disaster in Japan have been the major focus (and overhangs) of the markets, other issues remain as well. The European debt crisis with Portugal, the latest center of attention, remains an ongoing saga. Additionally, as we write this, we face the growing possibility of a federal government shutdown as Congress continues to battle over a new budget agreement. Countering some of these concerns, economic data continues to give evidence of a broadening recovery and optimism for higher equity prices. The March employment report, released on April 1, produced a mild positive surprise with non-farm payrolls increasing by 216,000. Importantly, the release also showed slightly less than anticipated wage growth, easing concerns that inflationary pressures would begin creeping into the labor market.

First Quarter 2011 Performance
During the first quarter of 2011 our composite of individual portfolios returned a total of 8.22%, outperforming our benchmarks once again. For comparison purposes, the NASDAQ Composite, the S&P 500, and the Morgan Stanley High Tech Index had 1Q increases of 4.83%, 5.42%, and 2.50%, respectively. However, when analyzing the S&P 500 by sectors, we note that only two sectors outperformed the overall index, Energy (up about 15%) and Industrials (up about 7%). We expect 1Q earnings conference calls to act as the next positive catalyst. This will give managements the first solid opportunity to quantify the impact of Japan and offer evidence that the disaster is a manageable disruption. This could propel the technology sector back into a market leadership position.

M&A: A Bullish Signal
One of our ongoing investment themes has been the bullish support that high cash levels (corporate, private equity, individuals, etc.) will bring to the equity markets. Money flows, surveys and anecdotal evidence suggest that investors are beginning to reallocate dollars to riskier assets. Similarly, corporate executives are gaining confidence in the economic outlook. One of the key uses of corporate cash is M&A. Despite the uncertainty engulfed around the globe, the end of March witnessed a flurry of acquisition activity within TMT (Tech, Media & Telecom) and elsewhere. Perhaps the first notable deal came from outside of TMT. It was Berkshire Hathaway's agreement to buy chemical company Lubrizol for roughly $10 billion. Announced at the height of the Japanese crisis on March 14, Warren Buffet's deal signaled that things would be okay and gave investors a big vote of confidence.

Further, on Monday March 21, AT&T announced that it would purchase T-Mobile USA from Deutsche Telekom for $39 billion. This deal, with its $25 billion cash component and $3 billion break-up fee, underscores a confidence that the regulatory and anti-trust environments are pro-business and supportive of corporate consolidation. Notable smaller deals within technology also took place. Later that same day (3/21), Shutterfly announced it would purchase privately-held Tiny Prints in a cash and stock transaction valued at $333 million (please see additional comments below). The following Monday March 28, eBay announced it would pay a 51% premium to purchase e-commerce specialist GSI Commerce for $2.4 billion.

Capping off the recent M&A activity, Texas Instruments announced it would pay a 78% premium to acquire fellow analog semiconductor firm National Semiconductor for $6.5 billion. These deals are notable not simply for their size and premiums paid. In each of these cases (except eBay where guidance was a little more murky), managements believe that synergies will result in earnings accretion either immediately or within twelve months. We see these announcements as supportive of many of our investments, particularly some of our small and mid-cap semiconductor names that we believe own important intellectual property and have first mover advantage in some key end markets.

Shutterfly (SFLY)

Followers of our work will recall that we have been big bulls on SFLY for some time. We have highlighted it in past podcasts and written about the company in past reports that are still available on our website. Despite its marked outperformance (up 96% last year, up 50% in 1Q11), SFLY remains one of our largest positions across our portfolios. We believe that management is still in the early innings of "disintermediating" the traditional physical storefront model involved in the process of photo printing, photo-sharing, scrap-booking, and sending greeting cards, with the more efficient technology-driven online model. We have been waiting for SFLY to consolidate the space and have viewed Tiny Prints (TP) as the best and most logical candidate to begin the process.

Tiny Prints has grown rapidly by delighting its customers in a manner similar to Shutterfly. Tiny Prints began with birth and wedding announcements before moving to holiday cards and advancing the online purchase of one-to-one greeting cards. We anticipate significant gross margin improvement for Tiny Prints as it moves its currently out-sourced card production onto SFLY's state of the art printing facilities. Also, the two customer bases should benefit from promoting SFLY's award-winning photobooks to the TP customer base and introducing the SFLY customer base to TP's high-end selection of cards, particularly the one-to-one greeting cards. Notable within the acquisition announcement was SFLY's disclosure that 1Q revenues and EBITDA were expected to be better than the guidance given on February 2. Clearly, SFLY's business momentum continues to surprise to the upside, strengthening our contention that the company could emerge as a category killer for a very large e-commerce marketplace.

As always, we welcome reader feedback and thoughts regarding new technology trends and ideas that are worth further analytical research. And, we thank our clients for entrusting us with their assets. Lastly, we would like to go on record as voicing a higher degree of skepticism than is found in the investment community regarding anti-trust approval of AT&T's proposed acquisition of the T-Mobile USA asset. Much can happen between now and the 12-18 months that it will take to gain approval, but this reminds us of WorldCom's effort to merge with Sprint in 1999-2000. After all was said and done, the Department of Justice blocked that deal in June of 2000, appearing to weigh heavily on the Herfindahl-Hirschman Index (HHI) of market share concentration. We expect market share concentration, with its potential effect on consumer pricing, to be a larger issue than analysts and investors currently anticipate with this deal as well. Stay tuned.

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