# VAN DIEN ASSET MANAGEMENT LLC
# THIRD QUARTER REPORT
## October 2011

To say the 3Q was a challenging period for investors is a major understatement. The inability of U.S. and European policymakers to deal with problems both here and abroad, has led to an economic slowdown and a severe crisis in confidence. The diminished confidence has led to a short-term pullback in spending at both the corporate and consumer level. While the unprecedented downgrade of U.S. Treasury debt by Standard & Poor's on August 5 may have been the quarter's defining moment, other issues have certainly added to the angst. The ongoing debate within Europe regarding its sovereign debt crisis has led to a leaky faucet-type of market that continues to lose value seemingly unabated week by week as investors fret over contagion risks. While the negative feedback loop that a falling market and decreasing confidence bring is difficult to quantify, our mindset has been that a double-dip recession is highly unlikely. In fact, we contend that a disconnect between economic growth prospects and investor sentiment has developed, as investors have rushed to the door.

Recessions are usually hastened by tight monetary policy combined with escalating interest rates and an accumulation of excessive inventories. These conditions do not currently exist. In fact, interest rates have dropped to levels rarely seen during the last fifty years. Thirty year US Treasury rates have dropped from 4.25% at the end of July to 3.02% at the end of September. Since 1977, the only time long-bond rates were lower was at the height of the financial crisis in December 2008. Similarly, ten year rates, down to 1.97% at the end of September, have never been this low in the past fifty years. Additionally, inflation appears benign, and Fed Chairman Ben Bernanke has indicated a willingness to continue the Fed's accommodative policy.

This leaves us with an equity market that is trading at less than 11x forward earnings at the end of September, based on consensus 2012 EPS estimates of $106.00 for the S&P 500. The market's median P/E for the past sixty years is closer to 15x. We would contend that the equity market has become oversold as investors react to the ongoing uncertainty and heightened market volatility. Obviously, we acknowledge significant risks including the deterioration of the political process in a divided Washington, the Euro Zone's debt burdens and associated austerity programs, as well as the ongoing U.S. unemployment problem. However, equity valuations would appear to reflect these uncertain headwinds or they would trade at 13-15x in our estimation. Investment alternatives, like fixed income, commodities, and real estate, do not appear to offer the same value opportunity as equities do currently.

Readers of our work will recall that a key underpinning of our generally positive investment rationale is the high level of cash balances on corporate balance sheets. In fact, the Federal Reserve recently reported that nonfinancial companies in the United States were holding more than $2 trillion in cash and liquid assets, and this doesn't include that held abroad in foreign subidiaries. Furthermore, a recent Bain study estimated that global private equity has an additional $1 trillion in dry powder. We believe that this cash will increasingly be put to work as visibility improves. In the meantime, corporate managements have shown great discipline in using their cash and managing their balance sheets. We believe a bullish signal was sent as several technology companies in our portfolios announced stock buybacks (Akamai, Riverbed, Coherent, for example) during the August onslaught. In respect to our holdings, also worth noting are the $1 billion share buyback announced by Scripps Networks on June 30 and the $1.5 billion buyback and 50% dividend hike announced by Corning on October 5.

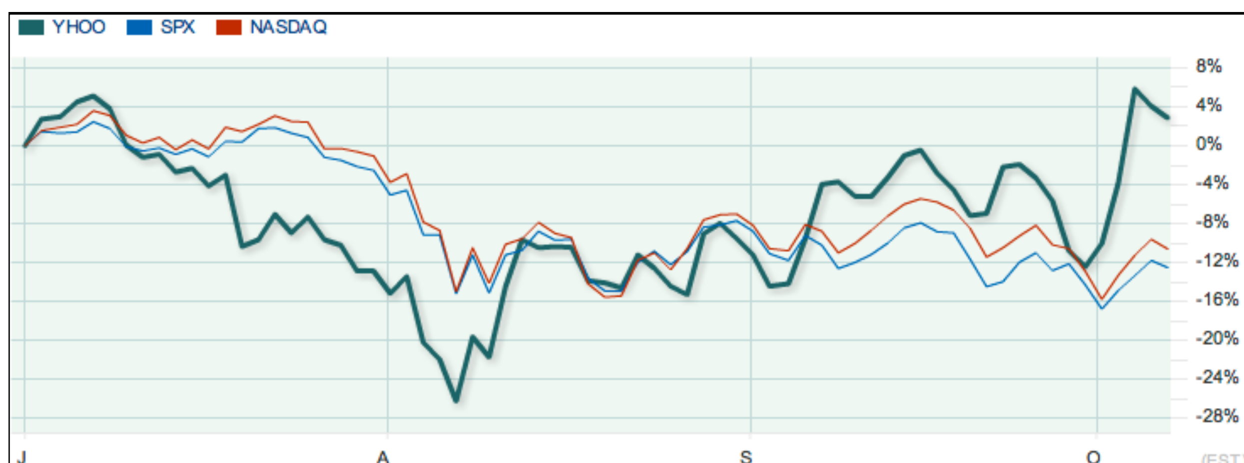
In regard to M&A, we wish to highlight that PAETEC, one of our core holdings within telecom services, agreed to be acquired by Windstream on August 1 in a stock transaction that valued PAET shares at a 27% premium to its previous close. Also, on September 12, Broadcom announced that it would acquire NetLogic Microsystems for $3.7 billion, a whopping 57% premium to NETL's previous closing price. Importantly, Broadcom was willing to move forward with its M&A process despite the ongoing market uncertainty and volatility. Additionally, Broadcom noted that it expects the deal to be accretive in year one and management reiterated its 3Q guidance within the press release.

These data points suggest to us that TMT consolidation will continue, especially within the semiconductor arena. Despite the consolidation trend, some companies have stepped too far. One megamerger that we've been skeptical of hit a big wall on August 31. That's when the Department of Justice sued to stop AT&T's proposed $39 billion acquisition of T-Mobile USA. Clients will recall that in our 1Q 2011 investment update we highlighted our skepticism of this deal ever gaining anti-trust approval, despite AT&T's spin and lobbying campaign that brought the labor unions, state regulators, and nearly everyone on Wall Street on board.

**YAHOO! -- A Case Study**

One company that we believe is essentially in play is Yahoo!, and we thought we would review the thought process behind our investment. We purchased YHOO shares in mid-May shortly after Yahoo! disclosed some questionable dealings over AliPay, a key subsidiary of its 40%-owned Alibaba Group, the Chinese ecommerce giant and crown jewel of YHOO's international assets. It is important to recognize that more than half of Yahoo's intrinsic value is contained in its portfolio of equity stakes of Asian internet assets. In a 10-Q filing, Yahoo! revealed that AliPay was shifted out of the Alibaba Group into a privately held Chinese company controlled by Alibaba CEO Jack Ma, without any formal board approval process or even YHOO's knowledge and consent. AliPay is the largest online payment solution in the world in terms of users (more than Paypal), and carried an estimated value of at least $500 million to YHOO at the time.

YAHOO! 07/01/2011-10/09/2011




The disclosure, which lacked detailed information, suggested a lack of oversight by both Yahoo's Board of Directors and its CEO, as well as a strained relationship with Jack Ma. The transfer of the asset left Yahoo! with no explicit ownership value for AliPay other than the promise of a future negotiated agreement. Obviously, it is difficult to negotiate proper value after the transfer has officially taken place. Additionally, the whole process, coming in the wake of recent frauds by U.S.-listed Chinese companies Longtop Financial and China Media Express, led investors to reassess the risk within Chinese equity investments broadly speaking. Needless to say, investors quickly abandoned YHOO shares as this news was digested.

Our thought process was that this debacle created an opportunity. We were aware of Greenlight Capital's (David Einhorn) recent stake accumulation (since divested) and that Yahoo CEO Carol Bartz was already on the hot seat. Furthermore, Yahoo's Board of Directors continues to be attacked for failing to capitalize on Microsoft's takeover overtures in 2008. Ultimately, however, we believed that YHOO would have to be reimbursed for its valuable stake in AliPay, or China could face greater difficulty in attracting foreign capital. Jack Ma would likely feel this pressure and over time a deal would be struck. The icing on the cake was YHOO's valuation, with the core business trading at 2-3x EBITDA. YHOO shares were priced for continued disappointment and it wouldn't take much for the stock to work.

As one can tell from the above chart, YHOO shares have begun outperforming as elements of the story have come together in recent weeks. On July 29, Yahoo and its partners, Softbank, and Alibaba, announced that it had reached an agreement over (future) payment for its ownership stake in AliPay. On September 6, the Yahoo Board fired CEO Carol Bartz and announced a strategic review. On September 9, hedge fund activist Daniel Loeb announced that his firm, Third Point, had accumulated a 5.1% stake and would seek to oust several Board members including Chairman Roy Bostock. As September rolled on an increasing number of names, including AOL, tech behemoth Microsoft (again), and private equity firm Silver Lake, have been reported to be interested in buying part or all of Yahoo's assets. Of course, YHOO founder and board member Jerry Yang and Alibaba's Jack Ma have also expressed interest. Any deal will

be complicated, but we believe that enough interested parties exist and that Yahoo, with its still impressive reach and user metrics, could create monetization benefits for the right partners. Yahoo is a case where continued operating disappointments within its core business create a stronger case for selling the company, or its pieces, to create value for shareholders.

**Performance**

As the market sold off in early August, some of our small and mid capitalization equities suffered significant losses. We believe that many of these names experienced greater than warranted selling pressure due to their cautious guidance. The fact is that many of the companies that reported 2Q results later in the cycle, notably after the S&P downgrade on August 5th, issued disappointing guidance, as managements appropriately incorporated the sudden freefall in the global equity markets and dramatic reduction in near-term economic visibility into their business outlook. Investors, wary of the uncertainty and with little visibility to hang their hat on, appear to have overly penalized many of these "late reporting equities". We have held onto these positions as we believe these names have greater upside surprise potential than companies that reported prior to the end of July when the debt ceiling negotiations really began to break down.

During the third quarter, VDAM was down 24.3%, hurt by our largest position Shutterfly (SFLY) which was down 28.3% and a group of smaller cap names. SFLY, a midcap equity with a high growth multiple, felt pressure as investors reined in their economic outlook and risk tolerance for high PE stocks. For comparison purposes, the NASDAQ Composite was down 12.9%, the S&P 500 was down 14.32%, and the Morgan Stanley High Tech Index was down 15.3%, for the 3Q. Year-to-date, through nine months, we have given up our midyear outperformance and are now even with the Morgan Stanley High Technology Index at down 16.1%. For the year, we are lagging the broader NASDAQ Composite and S&P 500 which are down 9% and 10%, respectively.

Our 3Q performance was poor and we are disappointed. In a time of near-panic, when sentiment rules the day and the market trades solely on the European Union's perceived ability or inability to reach a sovereign debt agreement, fundamental research takes a back seat. That noted, we have tried to invest in companies that have strong defensible and improving positions within growing end markets, where solid management teams and balance sheets can weather a period of uncertainty. Additionally, we strive to purchase these equities at what we determine to be reasonable valuations and at opportune times. Over an extended investment period or full economic cycle, we expect this disciplined approach to deliver better returns than one based on market timing and look forward to improved results.

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