Deteriorating Expectations

Chip Sector Under-performs Under-performing Equity Assets

The bad news is that the semiconductor industry appears to be entering a counter-seasonal slowdown in business conditions during a year of sector underperformance amid the broader equity markets. But the worse news is the unattractiveness of equities as an asset class as reflected by low trading volume, volatility, and relative underperformance amid the current financial, economic and political uncertainties around the world. If your investment time horizon can accommodate at least a year or two, then a large number of significant opportunities based on fundamental valuations are currently available. But the breadth and depth of current geopolitical uncertainties make for a very dicey situation over the next few months of the foreseeable future, in my opinion.

July Flatness: July was an anemic month for the semiconductor industry, as not unexpected. Chip industry statistics released early-September reported a pretty flat world-wide sales decline of only -0.1% on a three-month rolling average basis, which is about the most positive spin we can put on it. July is usually an okay month with average growth over the last 21 years of +1.4%, a high of +5.4%, and a low of -6.3%. However, this year's -0.1% is noticeably weak on a relative basis, and technically is only the fourth time in the last 22 years that July has fallen into negative territory. It is also troubling when put in context of a year that appears to be steadily eroding away: January grew noticeably above average; February was its normal weak; March exhibited normal growth; but then April declined abnormally after Japan's troubles in March; May bounced back to slightly above normal growth; but then June declined abnormally on macroeconomic weakness; and now we get July's abnormally weak flatness. Not inspiring. Japan was the only region that expanded with solid growth of +4.9% (probably due to earthquake, tsunami and nuclear disaster recovery) followed by Asia-Pacific that shrunk by -0.4%, the Americas by -1.4%, and then Europe by -2.4%.

August weakness to be reported next week may be able to avoid negative territory—but that's probably about the best we can hope for given the recent run of adverse 3Q pre-announcements. August has grown on average by +1.9% with a high of +5.2% and a low of -3.5% over the last 21 years, and only four of those 21 have been negative.

2Q Earnings Disappointment: Disappointment describes 2Q11. Yes, the earnings season started off with a very positive Bang! from the likes of IBM and Intel, but then steadily deteriorated as more and more companies announced mixed results that included uncertain and disappointing outlooks.

The good news was that some 23% of chip companies exceeded published expectations across reported revenue and earnings and subsequent quarter guidance, and a solid 36% met or exceeded those same parameters. Unfortunately, some 44% reported a mixed-bag of hits and misses and 19% just plain whiffed. Add these up, and 63% of companies reporting disappointed to investor expectations in at least some capacity. And even worse, it appeared as though 3Q guidance eroded as the earnings season progressed, where those companies with more bullish outlooks reported first and those with more bearish reported later—and even noted a steady deterioration in outlook over the prior few weeks within their own respective organizations. Such a trend continued into the 'pre-announcement season' over the last few weeks with no fewer than 18 companies having lowered revenue expectations as of this writing (and only one ticking up). Obviously, this does not bode well for the upcoming 3Q earnings season.

Lowered Expectations: Market researchers have also lowered chip industry growth expectations over the last few weeks that now reflect a modest expansion for 2011 in the low-single digits. The year is facing two strong headwinds: the mathematical curse coming off a year of strength with 2010 up by +33%; and now deteriorating business conditions as the year draws to a close—despite the traditional seasonal uptick.

Pockets of Light: A few pockets of strength persist amid the current macroeconomic malaise: smartphones, iPads and servers, to name a few. But even these areas only exist as subsets of broader markets exhibiting lackluster characteristics. For example: PCs overall are in a funk lead by weak consumer markets in the US and Europe, but business consumption continues to expand and developing countries around the world are posting double-digit growth; cell phone growth is slowing, but the smartphone segment lead by the iPhone and Android offerings are hot by almost any definition; and the blockbuster iPad remains in a class by itself (just what is it, anyway: an overgrown smartphone, or a stripped-down PC?). Companies serving these segments are faring better than most.

Tech Leads the Way--Down: The semiconductor sector has significantly underperformed this year relative to broader equity markets. Last month the Philadelphia Semiconductor Index Option (SOX) lost -8.1% while the S&P500 and NASDAQ fell by -5.7% and -6.4%, respectively—and the magnitude of the underperformance is even more pronounced for both the quarter and year, as shown in the table below. Notice that only two or three individual chip stocks out of over a hundred were able to post double-digit gains for the month and quarter, despite the sector's long history of cyclical growth and volatility.

August			
Winners *(12/105)*		**Losers**	
SPRD	30.4%	OVTI	-37.1%
INFN	17.0%	IPHI	-36.6%
AUTH	12.4%	TRID	-35.4%
NLST	5.3%	ENTR	-32.8%
RMTR	4.5%	QUIK	-31.8%
average stock -10.6%		*SOX -8.1%*	

QTD *(3Q)*			
Winners *(9/105)*		**Losers**	
IDCC	72.3%	SQNS	-58.5%
SPRD	12.1%	IPHI	-53.8%
INFN	8.8%	ENTR	-49.5%
BRCM	6.0%	OVTI	-47.1%
SIGM	5.5%	STEC	-44.2%
average stock -17.4%		*SOX -13.3%*	

YTD			
Winners *(17/105)*		**Losers**	
SIMO	152.9%	TRID	-76.4%
NSM	81.0%	MIPS	-63.1%
IDCC	69.1%	ENTR	-62.8%
AATI	49.9%	ANAD	-60.0%
TXCC	30.7%	IPHI	-60.0%
average stock -17.6%		*SOX -13.6%*	

Indices	***Aug***	***QTD***	***YTD***
SOX	-8.1%	-13.3%	-13.6%
SMH	-9.0%	-14.4%	-10.4%
NAS	-6.4%	-7.0%	-2.8%
S&P500	-5.7%	-7.7%	-3.1%
DOW	-4.4%	-6.5%	0.3%

Opportunities Abound for the Long Term: Broader macroeconomic issues have been driving share prices rather than industry fundamentals for several months now, not to mention the unattractiveness of equities as an asset class as reflected by low trading volume, volatility, and relative underperformance amid the current financial, economic and political uncertainties around the world. Fundamentals will continue to take a back seat to asset allocation over the next several months, in my opinion.

If your investment time horizon can accommodate at least a year or two, then a large number of significant opportunities based on fundamental valuations are currently available. But the breadth and depth of current geopolitical uncertainties make for a highly uncertain investment environment over the next few months of the foreseeable future, in my opinion.

—Dan K. Scovel
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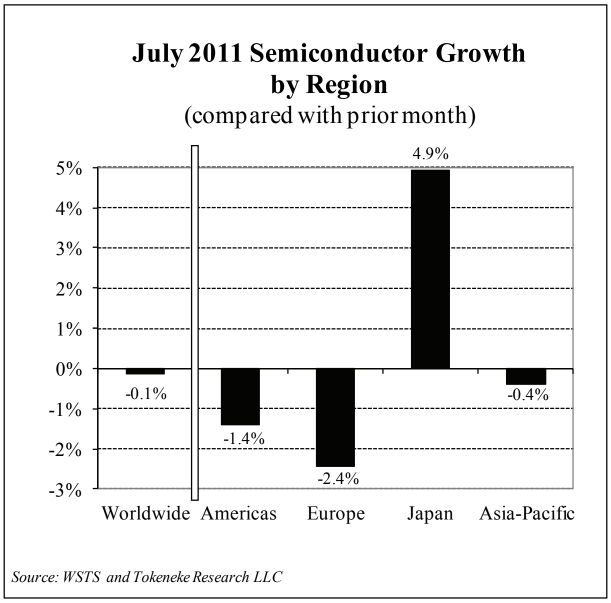
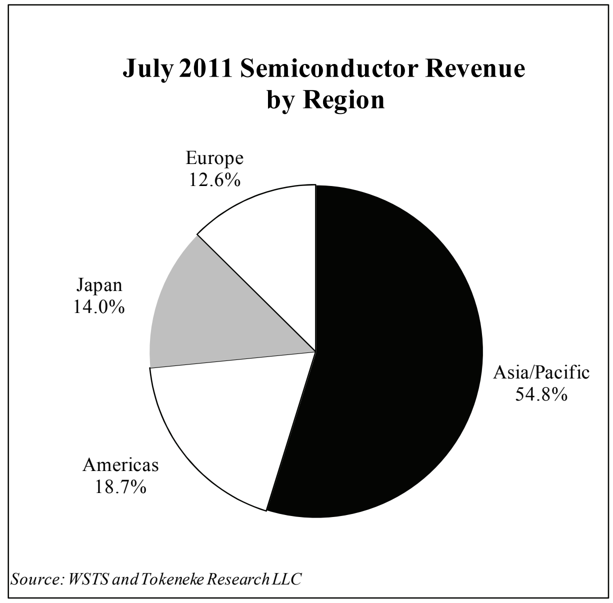
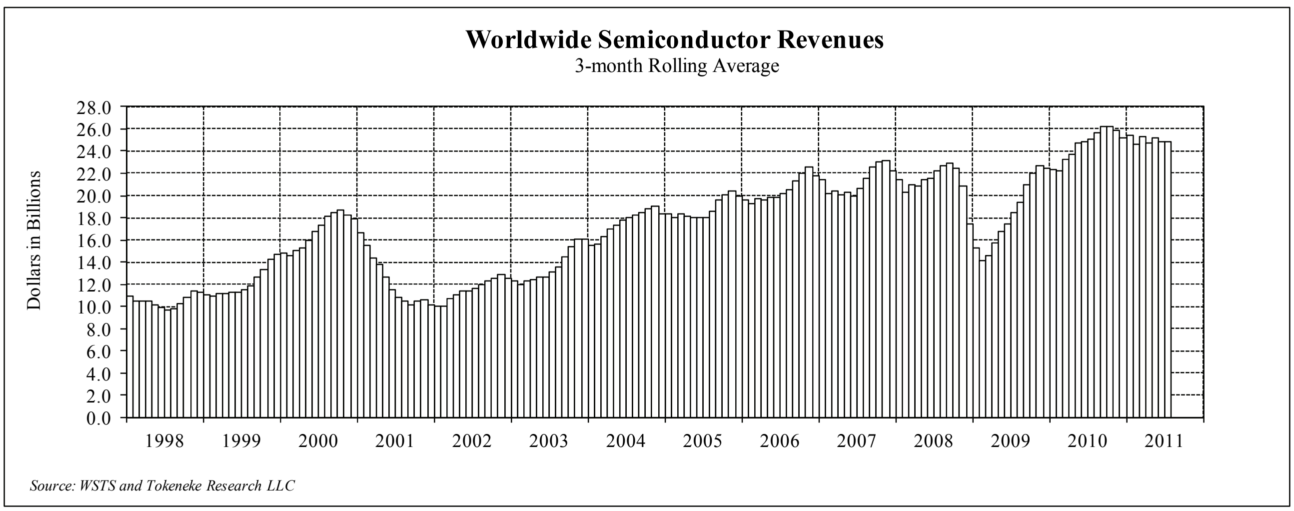
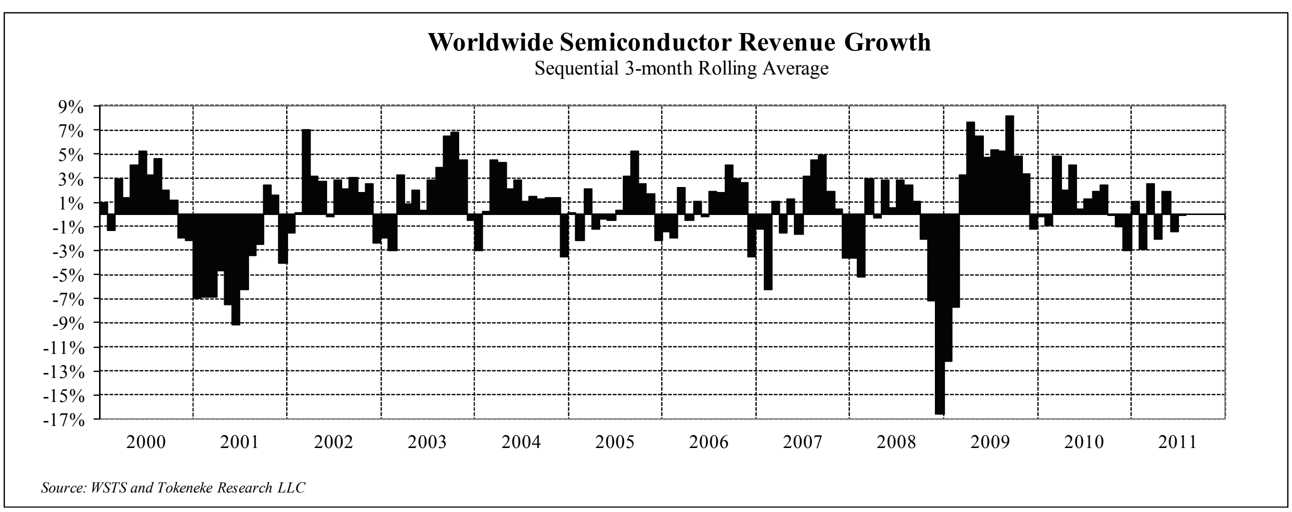
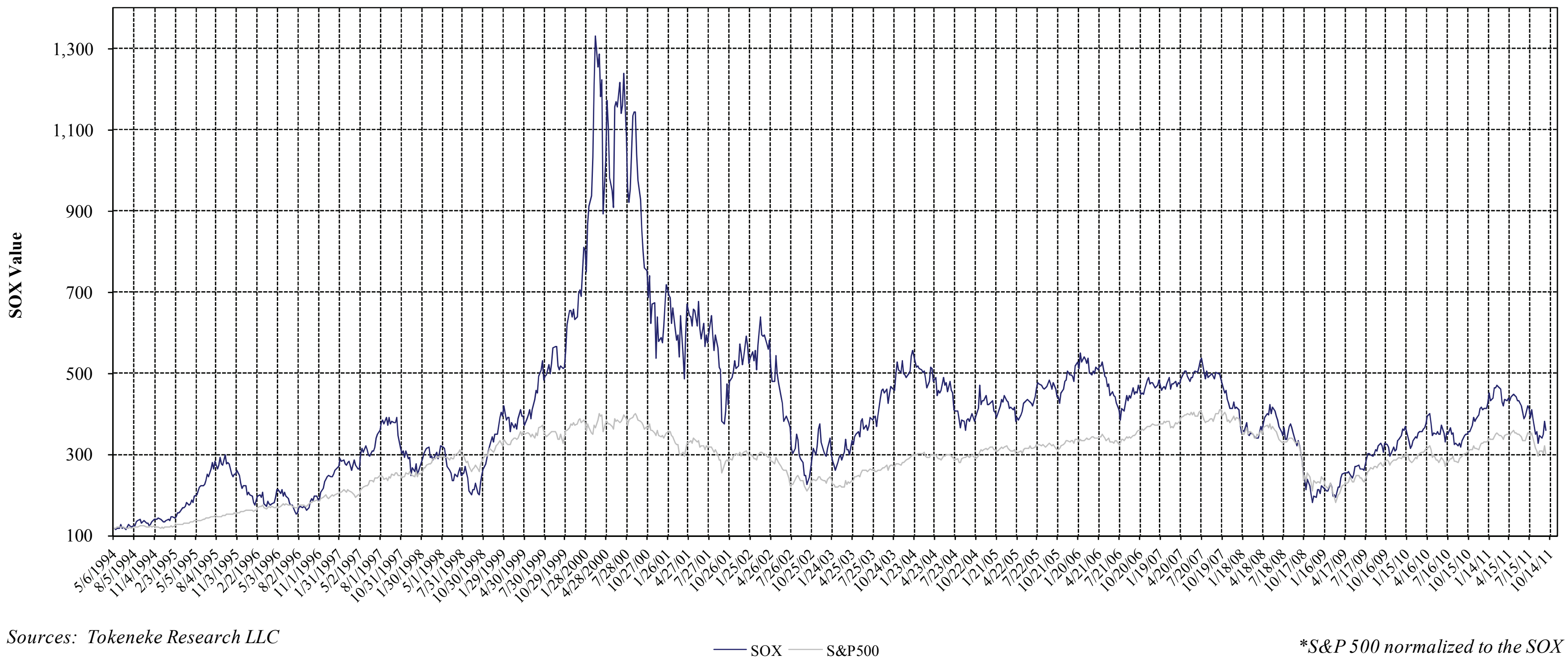

July 2011 Semiconductor Growth by Region
(compared with prior month)
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
4.9%
-0.1%
-1.4%
-2.4%
-0.4%
Worldwide
Americas
Europe
Japan
Asia-Pacific
Source: WSTS and Tokeneke Research LLC


July 2011 Semiconductor Revenue by Region
Europe 12.6%
Japan 14.0%
Americas 18.7%
Asia/Pacific 54.8%
Source: WSTS and Tokeneke Research LLC


Worldwide Semiconductor Revenues
3-month Rolling Average
Dollars in Billions
28.0
26.0
24.0
22.0
20.0
18.0
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Source: WSTS and Tokeneke Research LLC


Worldwide Semiconductor Revenue Growth
Sequential 3-month Rolling Average
9%
7%
5%
3%
1%
-1%
-3%
-5%
-7%
-9%
-11%
-13%
-15%
-17%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Source: WSTS and Tokeneke Research LLC

Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



Sources: Tokeneke Research LLC

**S&P 500 normalized to the SOX*

The Company

Tokeneke Research is an independent research firm specializing in semiconductor industry business issues, providing fundamental research focused on US equities across all market capitalizations within the sector to investors. The company was founded in 2005 and is based in Connecticut.

The Offering

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- *Industry Reports:* Publications offering insight and perspective to industry-wide, multi-year forecast updates; periodic sub-sector product type and end-market reviews; fundamental and valuation perspectives on sector equity relationships; and industry introductory overview. These are more detailed reports with varying shelf-lives, and are intended for narrow distribution to interested clients.
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My Background

I have an electrical engineering background, nearly 12 years of semiconductor industry experience, and was on Wall Street for nearly eight years where I was selected as the Best On The Street semiconductor analyst for 2002 by The Wall Street Journal, and third-rated Best of the Best across all sectors.

I obtained my undergraduate BS degree in electrical engineering from the University of Washington, and my MBA from Santa Clara University. My industry experience consists of nearly 12 years in various technical sales and marketing roles at four different semiconductor firms located in Silicon Valley beginning with Advanced Micro Devices in 1984, followed by two small start-up companies, and ending at Cirrus Logic where I supported the firm's Japanese market development. I joined Fahnestock & Co. as a senior semiconductor analyst in 1996 and was recruited by Needham & Co. in April 2000.

My formal coverage list as a sell-side analyst included the following equities: AMD, ALSC, ALTR, ARTI, ATML, CUBE, CY, ESST, GNSS, INTC, ISSI, LSI, MOSY, MU, OIIM, OVTI, RMTR, SIII, SMSC, STEC, SVTG, TDFX, TSRA, TXN, and ZRAN.

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