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Dear Valued Clients and Friends,

**MARKET PERSPECTIVE:** Fear Factor. The first quarter of 2004 was a great disappointment to say the least. The first several weeks of January started with a powerful rally, followed by a persistent decline, all within the trading range that the market has been locked in since the end of the third quarter of 2003. During this first quarter the list of great fears swung from a fear of deflation to one of inflation. On the economic front, we managed to switch from a “jobless recovery” to wage inflation created by the dearth of new jobs. In the world economy, the Chinese economy was viewed as overheated and inflationary. At the mere suggestion that the Chinese government might tap on the brakes, the fear immediately became related to the severe impact of China’s insatiable demand for the rest of the world’s exports. The only consistent feature was the justifiable fears of terrorist attacks, which were renewed with the shameful bombing of the train system in Spain, not to mention the large number of smaller attacks in a wide variety of geographic locations. The side effects of these senseless acts were their impact on oil prices and the dramatic increases at the pump. Last but not least, the fear of rising interest rates took on a life of it’s own; even the Fed had suggested that rate increases would be orderly and incremental in nature. The fear of the unknown has always been adverse to stock pricing and in this case has paralyzed portfolio managers and analysts creating a distinct lack of buying, thus leading to lower prices. Aside from these fears, there was a tremendous improvement in corporate profits across most industries this quarter driven by an undeniably improving economy. These profits went virtually unnoticed. As of this writing, it would appear that there is little left to fear but fear itself. This should lead to much better days ahead.

**TECHNICAL OUTLOOK:** Fake Out!!! The once strong leadership qualities (i.e. large number of good chart patterns vs. bad, quality of leadership, increasing volume on up days and light volume setbacks) indicative in our last letter have abruptly reversed. In sharp contrast to January’s outlook:

1. The majority of chart patterns have not followed through and many have broken down.
2. The aforementioned high quality leader board has been replaced with a small number of inflation sensitive groups not typically associated with a healthy market environment (i.e. energy, metal and commodity related industries).
3. Volume is prominent on the down days and almost non-existent on the up days.

As the market gropes to find its ultimate low, caution is recommended as we await technical confirmation that a new uptrend has begun. In our opinion, this will happen much sooner than later.

**SECTOR OUTLOOK:** Mixed Bag. The leader board has been made up of sectors that reflect an inflationary environment: industrial and precious metals, most oil and gas related sectors, and other commodity price sensitive industries. The quality leadership groups that remain are the biomed-biotech, medical systems and equipment group and more recently the medical-ethical and specialty pharmaceutical companies. In the high tech sector, internet content and computer software security remain in favor. The once sizzling wireless communication sector has corrected sharply and will need to regroup before a new advance. The hardest hit groups, those being mortgage related services, homebuilders residential/commercial, and real estate investment trust would be adversely affected by a higher interest rate structure and should be avoided for now.

**PORTFOLIO ADJUSTMENTS:** Sad but true. As sad as it is, people have been forced to come to grips that terrorism and war is a part of their daily lives. As much as we would all like to put these horrors behind us, they will be a part of this country for the foreseeable future. Two of our new additions to the portfolio this quarter are not direct plays on a prolonged war, but are good growth companies that have a war component to them. This strategy allows us to not only invest in two companies that have great prospects if the world's troubles end tomorrow, but also to invest in a trend if the world's troubles do not.

- Ultralife Batteries (ULBI \$18.34)\* is not planning on replacing the Energizer Bunny anytime soon. Actually, we are sure the likes of the big battery manufacturers like Energizer and Duracell have never even heard of Ultralife Batteries. For a giant billion dollar company like Energizer, if a battery does not have a big market, the reward is not worth the effort to design the manufacturing process to make the batteries. Ultralife's competitive advantage is they have perfected the manufacturing process to work with batteries that have a small market place. So when the U.S. military needed a specialized battery that would hold up to extreme temperatures and last long, Ultralife got the order with little competition. The U.S. military has been their biggest customer for the most recent years, but Ultralife sees the military as only their 3<sup>rd</sup> biggest market. They are taking the same manufacturing process used to create specialized military batteries into areas such as the health care market, radios, fire alarms, search and rescue, RFID, and automotive telematics (Onstar).
- Verint Systems (VRNT \$26.74)\* is a terrorist's worse nightmare. Verint specializes in software that allows analysis of mass amounts of communication whether it is sent via fax, video, email, internet or voice for government and business intelligence reasons. Since 9-11, increased support from the United States government and other countries around the globe has made communication interception more acceptable. As the trend of such national initiatives as Homeland Security continues, monitoring of communications around the globe will be a strong trend regardless of how much fear of terrorism is in the future.

**COMPANY UPDATES:** Growth continues. Our portfolio was a great representation of the previously mentioned strength in corporate earnings for the quarter. From hair removal to the iPod, DVD's to portable ultrasound, health insurance to heart monitors, growth continues to be strong in our companies. The majority of our core holdings did not only achieve already lofty growth expectations, but beat the consensus estimates. More importantly, we believe that the positive growth seen in this quarter is only a sign of things to come as most of our companies have growth catalysts coming in the next couple of quarters. Below is a sampling of the growth that we looked at during the quarter:

- Led by increased market penetration with its unique light-based hair-removal product, Palomar Technologies (PMTI \$16.47)\* beat their growth expectations by achieving year-over-year quarterly revenue growth of 58% and net income three times higher when compared to last year. Catalyst: New products such as an acne product which are simple add-ons for current customers.
- Sonic Solutions (SNIC \$18.17)\* beat estimates by achieving 82% year-over-year quarterly growth based on continued strength in their newly configured Dell agreement. Sonic also recently announced an extension of their current agreement with Microsoft allowing Microsoft to license Sonic's burning technology in all aspects of Windows. This further confirms our belief that an investment in Sonic Solutions is more than the positive trend in the DVD burner market, but is instead an investment in a technology that is the cornerstone for any type of DVD/CD creation. Catalyst: Mainstream adoption of DVD burners.
- Sonosite (SONO \$21.19)\* beat consensus estimates by achieving revenue growth of 37% on the same scale led by growth in their new product, the TITAN, which already accounts for close to half of their total revenue. Catalyst: Japanese market expansion.
- HealthExtras (HLEX \$13.69), a regional pharmacy benefit management company (PBM), reported top line revenue growth of 21% and net income growth of 79% year-over-year quarterly revenue which beat consensus estimates. They continued to mark their niche in the PBM market as the leader for small to mid-sized companies. Catalyst: Continued regional expansion.
- F5 Networks (FFIV \$26.32)\* handily beat consensus estimates by growing revenues 45% year-over-year by continued international growth and blockbuster growth in their newly acquired SSL VPN product. Catalyst: Continued growth in SSL VPN.

Regardless of war, terrorism, inflation, deflation, unemployment, over-employment and increased gas prices, American businesses will continue to be proactive and companies will continue to grow. Thank you for taking the time to read our thoughts. We always appreciate any questions that you may have, so do not be hesitant to call.

Sincerely,

J.D. Hurd  
 President  
 Senior Portfolio Manager

\*Prices as of 5/18/04. The information concerning the stocks contained herein should not be construed as a recommendation to buy or sell them in your individual investment accounts. The opinions expressed are those solely of Rocket Capital Management, LLC.