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Telecom Overview: FCC Feels Its Oats

The recent moves by the Federal Communications Commission show just how serious the agency is about exploring how far it can extend its power.

On Tuesday, the FCC ruled that voice-over-broadband (VoBB) services, such as those offered by **Vonage** and **AT&T** (T:NYSE), are interstate services and therefore fall under the jurisdiction of the FCC and not individual state public utility commissions (PUCs). It also confirmed that computer-to-computer communications, such as those offered by **Free World Dialup**, are information services and not communications services, which means that they will be subject to hardly any regulations.

These rulings are very bullish for voice-over-Internet protocol (VoIP) and will enable these carriers and their suppliers to innovate, build out and grow. For example, consider the difference it will make for Vonage if it only has to meet the FCC's requirements rather than having to meet the regulations of 50 different states. The implications are huge, and if this ruling does stick, it will help VoBB adoption and innovation tremendously. So, indeed, that's the "sticking" point: Will these regulations *stick*?

Shockingly, the regional Bell operating companies (RBOCs), which will have the most to lose from an accelerated VoIP-adoption cycle, are endorsing the decision. I take their endorsement as yet another subtle affirmation of their fiber-centric future and a signal that they have accepted that the days of copper telephony cash cows are ending. The RBOCs want to make sure the FCC's power to end the UNE-P (unbundled network elements - platform) subsidization of their competitors sticks, and undermining the FCC's reach on VoIP isn't the way to do that. So they are being supportive.

This means that the biggest threat to the FCC's power over VoIP becomes the state PUCs. The state agencies are only ones set to lose here, and given that the nature of bureaucracies is always simply to extend their own existence and power (the FCC here is a prime example), I do expect some appeals of this ruling, which might very well end up before the Supreme Court at some point in the next few months.

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Frankly, though I hate to say it, the state PUCs' case can certainly be made. Their charters call for them to regulate their local voice communications, and as much as the industry wants to pretend that VoIP somehow isn't a communications service, it is. VoIP is voice communications, and if someone in Minnesota calls someone else in Minnesota, well, that's not interstate. And that, again as much as I hate to say it, simply falls under the jurisdiction of the state PUC.

So this could still get messy. But if I were pressed to make a prediction, I'd say the cards are stacked in the FCC's favor, and these rulings, like the recent fiber rulings that exempt fiber networks from unbundling, are very likely to stick. Specifically, the somewhat conservative Supreme Court and the people in control of the White House, Senate and House of Representatives help the FCC's cause.

The Next Step

Assuming the regulatory regime gets fully behind VoIP, the last obstacle keeping the technology from making a true leap to prime time is simplicity. It's just too hard and confusing for the average consumer to understand and hook up the VoIP offerings out there. You know how to plug in your telephone to that little hole in the wall that you, your parents and your grandparents have used for the past few decades. But when you sign up for VoIP you might get some fandangled little box that begs a host of questions:

- I connect this thing to my cable modem and that somehow will allow me to talk from my bedroom, too?
- Do I need to reboot this thing to connect my WiFi-enabled PC?
- Do I need a new phone system to make calls from other rooms? (You do, but that's sort of the point, too, isn't it?)

It's just not cut-and-dried, and it's not simple enough yet. It's getting there, as Vonage and AT&T and others are working with **Netgear** (NTGR:Nasdaq), **Linksys** and others to roll out products that are closer to the classic KISS (keep it simple stupid) standard, but we're not there yet.

But simplicity or not, VoIP is gaining momentum with this new regulatory tailwind behind it, so what are the names to be involved with?

Well, as AT&T continues to move away from its old-school long distance and UNE-P local services, it is also getting more and more serious about its VoBB offerings. And the company's got the marketing clout and name to really make some gains. But it will take at least a couple of years before AT&T's VoBB offerings have much impact on its top and bottom lines.

8X8 (EGHT:Nasdaq) drives me crazy, seemingly putting out a press release every time it signs up an actual customer, but the company might finally be poised to grow. To my mind, **deltathree** (DDDC:Nasdaq) is a more interesting and better-run company, as it has been growing its customer base and revenue by executing on its business plan.

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If the cable companies figure out that they should take the marketing effort for their voice offerings beyond sending customers junk mail, cablecos will also benefit. **Comcast** (CMCSA:Nasdaq) especially could do well in VoIP, but like AT&T, we're talking many quarters before VoIP will have much impact on its financials.

Last, although the new regulatory moves don't necessarily enhance the prospects for these stocks, **Broadwing** (BWNG:Nasdaq), **XO Communications** (XOCM:OTC BB) and the other competitive local exchange carriers (CLECs) that won't be affected by the end of UNE-P, but have been punished by the Street all year, will also find their regulatory lives easier. Most offer several different flavors of VoIP and will get some regulatory relief.

Cisco Follow-Up

Finally, on Tuesday night, **Cisco** (CSCO:Nasdaq) reported earnings, which were fair to poor. By now everyone knows the company met expectations for the last quarter with earnings of 21 cents per share and \$6 billion in revenue, but it guided next quarter lower than the Street's consensus of 3% to 4% sequential growth, and is looking for only 1% to 3%.

Digging beneath those numbers reveals some important dynamics that have serious investment implications. Cisco saw a double-digit sequential decline in router sales to carriers, which confirms that **Juniper** (JNPR:Nasdaq) is taking serious market share in the core of the network, something I've written repeatedly in recent newsletters.

Cisco coyly tried to blame the losses on its rollout of a new, higher-capacity router that slowed sales. I don't think that's the case at all. It's simply a case of Juniper taking market share and carriers finding a higher return on investment on their Juniper routers.

As the carrier router segment is in a secular growth cycle and Juniper is continuing to take market share, I continue to like Juniper here. I will hold the large position in the model portfolio even though the stock has rallied some 25% in recent weeks.

I would also note Cisco's inventory levels. They remained flat quarter over quarter, and that means component suppliers like **Applied Micro Circuits** (AMCC:Nasdaq) will likely continue to face lumpy sales cycles at best, and at worst, more problems from inventory gluts below them in the supply chain. Applied Micro will remain an interesting value play at these levels, but until Cisco and the other companies clean out the inventories on their sheets and in their supply chains, visibility and catalysts will remain low.



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The Telecom Connection Portfolio

Company Name	Portfolio Inception	Cost Basis per Share	Number of Shares	Amount Invested	Current Price	% Gain/Loss Since Portfolio Inception	IXTC at Buy Date	IXTC Return
ADC Telecommunications ADCT	12/10/2003	\$ 2.86	6000	\$ 17,130.00	\$ 2.44	-14.54%	\$ 169.05	7.37%
Advanced Fibre AFCI	02/24/2003	\$ 19.93	800	\$ 15,941.24	\$ 15.72	-21.11%	\$ 114.13	59.04%
Alliance Semiconductor ALSC	01/28/2004	\$ 7.50	2000	\$ 15,000.00	\$ 3.26	-56.53%	\$ 200.60	-9.52%
Applied Micro Circuits AMCC	02/12/2003	\$ 4.03	3000	\$ 12,082.00	\$ 3.35	-16.82%	\$ 111.88	62.24%
AudioCodes AUDC	11/12/2003	\$ 10.74	1500	\$ 16,115.00	\$ 13.06	21.56%	\$ 170.79	6.28%
Avanex AVNX	08/13/2003	\$ 4.10	3500	\$ 14,353.00	\$ 2.97	-27.58%	\$ 148.07	22.58%
Bookham BKHM	04/09/2003	\$ 14.36	1300	\$ 18,674.00	\$ 4.98	-65.33%	\$ 119.80	51.51%
Broadwing BWNG	08/27/2003	\$ 12.60	540	\$ 6,804.00	\$ 5.67	-55.00%	\$ 150.85	20.32%
Cisco CSCO	10/04/2002	\$ 9.82	300	\$ 2,946.00	\$ 18.44	87.78%	\$ 88.90	104.17%
Dycom DY	06/23/2004	\$ 27.40	300	\$ 8,220.00	\$ 33.79	23.32%	\$ 178.76	1.54%
Emcore EMKR	03/10/2004	\$ 4.31	2000	\$ 8,620.00	\$ 2.22	-48.49%	\$ 187.94	-3.42%
F5 Networks FFIV	06/16/2004	\$ 29.46	300	\$ 8,839.00	\$ 41.47	40.75%	\$ 180.24	0.70%
Finisar FNSR	07/09/2003	\$ 2.01	6000	\$ 12,035.00	\$ 1.75	-12.75%	\$ 158.68	14.39%
Corning GLW	09/09/2004	\$ 10.50	500	\$ 5,250.00	\$ 11.73	11.71%	\$ 174.75	3.87%
IDT Corp. IDT.C	04/09/2003	\$ 15.69	1192	\$ 18,703.04	\$ 13.37	-14.79%	\$ 119.80	51.51%
Interwoven IWOV	04/09/2003	\$ 7.40	668	\$ 4,943.20	\$ 9.56	29.19%	\$ 119.80	51.51%
JDS Uniphase JDSU	09/26/2002	\$ 2.64	8500	\$ 22,420.00	\$ 3.13	18.67%	\$ 92.19	96.89%
Juniper JNPR	02/09/2004	\$ 25.95	800	\$ 20,762.00	\$ 27.17	4.69%	\$ 194.99	-6.91%
Motorola MOT	06/17/2004	\$ 18.40	500	\$ 9,200.00	\$ 17.18	-6.63%	\$ 179.63	1.05%
MRV Communications MRVC	08/20/2003	\$ 2.41	13000	\$ 31,380.00	\$ 3.87	60.33%	\$ 150.78	20.38%
Microsoft MSFT	09/26/2002	\$ 23.33	800	\$ 18,658.00	\$ 29.73	27.46%	\$ 92.19	96.89%
Nortel NT	04/16/2004	\$ 5.50	1000	\$ 5,500.00	\$ 3.58	-34.91%	\$ 185.78	-2.30%
OmniVision OVTI	07/20/2004	\$ 12.47	1000	\$ 12,470.00	\$ 16.11	29.19%	\$ 172.73	5.08%

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Polycom PLCM	04/09/2003	\$ 8.87	564	\$ 5,002.68	\$ 21.07	137.54%	\$ 119.80	51.51%
Sycamore SCMR	08/27/2003	\$ 4.50	5000	\$ 22,524.00	\$ 3.60	-20.09%	\$ 150.85	20.32%
Sonus SONS	04/01/2004	\$ 3.48	1500	\$ 5,220.00	\$ 5.29	52.01%	\$ 184.27	-1.50%
Sun Microsystems SUNW	10/02/2003	\$ 3.67	3000	\$ 10,998.00	\$ 4.60	25.48%	\$ 159.65	13.69%
Tekelec TKLC	03/17/2004	\$ 17.48	800	\$ 13,981.00	\$ 22.99	31.55%	\$ 182.08	-0.31%
Tellabs TLAB	09/08/2004	\$ 9.57	500	\$ 4,785.00	\$ 7.95	-16.93%	\$ 172.12	5.46%
Teleglobe TLGBE	08/14/2001	\$ 9.92	3000	\$ 29,760.00	\$ 3.51	-64.62%	\$ 274.21	-33.81%
Microtune TUNE	09/24/2003	\$ 2.60	2500	\$ 6,500.00	\$ 4.87	87.31%	\$ 166.08	9.29%
Time Warner Telecom TWTC	10/09/2003	\$ 9.06	1000	\$ 9,062.96	\$ 4.68	-48.36%	\$ 169.16	7.30%
Verizon VZ	12/04/2001	\$ 43.60	300	\$ 13,080.00	\$ 41.17	-5.57%	\$ 239.44	-24.19%
XO Communications XOCM	05/21/2004	\$ 3.90	3000	\$ 11,690.00	\$ 3.06	-21.47%	\$ 172.49	5.23%
Zilog ZILG	05/19/2004	\$ 7.53	2500	\$ 18,825.00	\$ 5.65	-24.97%	\$ 171.91	5.58%

The Telecom Connection Portfolio – Performance

Total Average Return -7.81%

2004 YTD Return -15.36%

Performance results listed here reflect values of stocks as of the close of the most recently completed trading day, and do NOT take into account dividends paid, interest earned or commissions. Results are updated overnight and posted prior to the market open the following business day. The 2004 YTD Return figures reflect changes since the beginning of 2004. The Total Average Return figures reflect changes since inception on 9/26/2001.

Nasdaq Telecom Index Performance

	Portfolio Inception	Open Price	Current Price	% Gain/Loss Since Portfolio Inception	2004 YTD Return
Nasdaq Telecom Index (IXTC)	8/14/2001	\$ 270.32	\$ 181.51	-32.85%	-1.73%

At the time of publication, the buy-side firm in which Mr. Willard is a partner was net long: ADCT, AFCI, ALSC, AMCC, AUDC, AVNX, BKHM, BWNG, DY, EMKR, FFIV, FNSR, GLW, IDT/C, IWOV, JDSU, JNPR, MOT, MRVC, MSFT, NT, NTGR, OVTI, PLCM, SCMR, SONS, SUNW, TKLC, TLAB, TLGB, TUNE, TWTC, XOCM, ZILG.

To see Cody's full portfolio, including closed positions, visit
<http://www.thestreet.com/k/tc/portfolio.html>.



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