Issue 337: Wednesday, September 24, 2008

In This Issue

Telecom Overview:
Seek Out True Causes for Current Crisis

In this week's edition of *The Telecom Connection*, I'm doing a little something different. In addition to being a tech junkie, I'm also a news/politics junkie, and as such I have grown more than a little irritated at all of the commentary about the nation's current financial crisis.

I've found the vast majority of the comments on *RealMoney* to be intelligent, insightful and educational. But many of the other sources of information, particularly the major media outlets, are elevating my blood pressure. I realize they're all fighting for the big story, but I'm bothered by the general failure to investigate the genesis of the markets' current problems. I'm also dismayed by the suggestion that this is somehow an indictment of the free markets.

I suppose I shouldn't really be surprised. But for me, nothing could be further from the truth, and I'll explain why.

There are two additional points I want to address. First, **Cypress Semiconductor's** (CY) distribution of its **SunPower** (SPWR) holdings will take place next week and I have added some comments on the details of that transaction. Second, as many readers will remember, there was a large put position in **MEMC Electronics** (WFR) in the model portfolio earlier this year. It was closed it out during the summer due to some pricing problems in the model portfolio. At the time, I noted that this sale was not done because I had changed my mind regarding the position. If any readers elected to continue with the puts, they're up about 200% at this point, and I would recommend closing that position out with a smile.

Wrapping up this week's newsletter, **Research In Motion** (RIMM) and **Micron** (MU) are scheduled to report earnings this week, so I'll provide a quick update about what I'm expecting to hear from both names. Also, readers should note that the **Microtune** (TUNE) September $5 calls (TQTIA) that were in the model portfolio expired last week. So those 25 calls have been zeroed out in the portfolio.

(Continued on the next page)

Bob Faulkner
The Telecom Connection
An Insider's View into the Telecom Industry
TheStreet.com

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My Take on the Root of the Present Upheaval

As the markets deteriorated over the past several weeks, there have been numerous comments and opinions on *RealMoney* and elsewhere regarding the current crisis, its underpinnings and what to do next. What I've found most troubling is the propensity of some to use the current situation as proof positive in their minds of the failure of the free market system, the failure of capitalism and the need for a more stringent regulatory environment.

Whether you're in one camp, the other or in neither, I think it helps to consider that this crisis derives from two points:

- The disproportionately large number of subprime mortgages in or likely to be in default; and.

- The impact of mark-to-market accounting on the holders of mortgage-backed securities (MBS).

So what are the origins of the aforementioned issues?

In 1992, the **Federal Reserve** Bank of Boston published a report citing racial discrimination in the mortgage lending industry. The report, *Mortgage Lending in Boston: Interpreting HMDA Data*, generated much controversy and criticism but certainly no rational person can accept discrimination in any form anywhere.

However, that same Boston Fed -- imbued with its need to "help" -- also provided us with something that looks more like "The Idiots Guide to Mortgage Approvals," a.k.a. *Closing the Gap: A Guide To Equal Opportunity Lending*.

In commenting on underwriting standards as they apply to the minority community, this document notes that processes or mechanisms used in the past may "contain arbitrary or unreasonable measures of creditworthiness." Furthermore, it notes that, "special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower-income, and non-traditional consumers." Items cited as possibly being arbitrary or unreasonable include points such as credit and employment histories. The pamphlet suggests alternatives that should be considered in place of such "traditional" metrics.

However, what it fails to address is whether the suggested alternatives carry any predictive value in determining who is or is not likely to default on a loan, as well as the statistical evidence supporting such a claim.

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Whether you agree with the underwriting modifications or not, what this did was open the door for many more sub-prime mortgage loans. And such loans, due to their nature, carry a higher interest rate and, frequently, adjustable interest rates.

Armed with this information, the Clinton administration took action on two fronts.

First, the Justice Department retooled the Community Reinvestment Act, a 1977 law designed to motivate banks to “invest” (i.e., lend) more in minority communities. Bank examiners now scored banks on cold, hard numbers as to how much “investing” they were doing, and a failure to obtain a passing grade would mean trouble for any bank in the highly regulated industry.

Not only was the Justice Department watching over banks and insurance companies (for homeowners insurance), but it also heavily encouraged “community groups” to get involved. Consequently, groups like the Association of Community Organizations for Reform Now (ACORN) and the Neighborhood Assistance Corporation of America (NACA) were given the opportunity to run what amounted to extortion rackets against banks. This situation was well documented nearly a decade ago in a comprehensive article in the urban-policy magazine *City Journal*.

Government-sponsored entities like **Fannie Mae** (FNM:NYSE) and **Freddie Mac** (FRE:NYSE) also became proactive on minority lending. These institutions buy mortgages from the originators, securitize them in bundles and resell the securities to investors. For decades, such MBS were among the safest and most liquid securities available to institutional investors worldwide.

However, as was reported in a recent issue of the *Village Voice*, the Department of Housing and Urban Development (HUD) was essentially operating in tandem with the Justice Department. Then HUD Secretary Henry Cisneros, followed later by Secretary Andrew Cuomo, increased the percentage of subprime mortgages that could be purchased and held in the Fannie/Freddie portfolios. This created a ready buyer for such loans from mortgage lenders. In fairness, those same subprime policies remained in place at Fannie/Freddie during the Bush administration as well.

This helps answer the question I’ve been asked a number of times over the past few weeks: “Why would anyone give someone a mortgage when they knew the person couldn’t pay it back?” Simple -- because the mortgage originator never held the mortgage, it was sold to Fannie/Freddie. However, when Fannie/Freddie packaged mortgages into a bond offering (or MBS), the institutions buying that paper did not know the mortgage composition being used as collateral. After all, this was among the safest of all markets for decades and there was the implied guarantee of the U.S. government.

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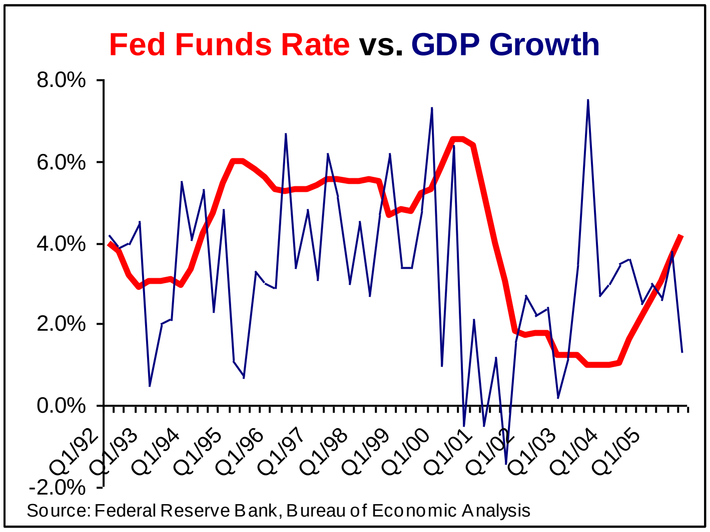
One last event that helped push even more mortgage money into the subprime arena was the "easy money" policies from Federal Reserve Chairman Alan Greenspan. While he has disavowed all such responsibility, a quick look at the graph below demonstrates two things. First, that he was slow to react to the weakening economy in 2000; and second, that the federal funds rate was too low for too long. From the first quarter of 2003 through the second quarter of 2004, fed funds never exceeded 1.3% despite what was clearly a "recovered" economy.

What this means from a mortgage market perspective is relatively simple. If I can borrow from the Fed at 1% and lend it out at 4% or 5%, I'd be nuts not to do it. However, traditional customers can only take so much. Once homeowners refinance for the first, second or even third time, an increasing amount of attention and resources swing toward the less-penetrated markets: subprime.



I think at this point you can see how the subprime bubble was created. Now I'll look at the ramifications for the holders of MBS, and it's here we get a look at the role of our friends, "The Regulars."

If you think back to the early part of the decade, the bubble burst and we endured more than a few high-profile corporate scandals. In an attempt to "solve" the abuses from the likes of Enron, Worldcom, Tyco, et al., various regulatory bodies brought us mark-to-market accounting requirements. In essence, what this means is that the value of your liquid assets -- such as bonds, notes, CDs, etc. -- are adjusted to reflect market value on your balance sheet vs. carrying them at their cost. And on the balance sheets of many banks, mortgage companies, insurance companies, Fannie/Freddie, etc. are hundreds of billions in MBS, which had been among the safest and most liquid securities available for decades.

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What our regulator friends failed to anticipate was the velocity with which any security, or MBS in particular, could change. And in the highly regulated financial services industry, entities are required to maintain specific ratios of invested capital to assets. If your assets plummet over a matter of days, you're scrambling around for a capital infusion or you're bankrupt.

So the chain reaction goes something like this:

• The Federal Reserve starts raising interest rates to slow the economy and/or stem inflation;

• Many of the subprime mortgages that never should have been made go into default, and as interest rates increase, that accelerates along with foreclosures;

• Default rates on subprime mortgages become far higher than historical averages and depress the market value of MBS until there is no market for them at all; and

• Holders of MBS scramble for capital infusions and/or fail.

Now we are faced with the rhetoric of "free market failure," and those whose actions may have contributed the most to the disaster are expected to fix it. You decide!

Upcoming Earnings

Two model portfolio companies will be reporting over the course of the next week. Here's a quick overview of what I'm expecting from each.

• **Research In Motion** (RIMM)
The company will report earnings after the close Sept. 25, with a conference call scheduled for 5 p.m. EDT. Current consensus estimates are for revenue of $2.59 billion -- up 89% year over year and up 16% quarter over quarter -- and earnings per share (EPS) of 87 cents.

There have been a lot of mixed messages from the Street over the course of the past month or so regarding Research In Motion. Many were worried that because the new BlackBerry Bold didn't ship domestically, that will hurt the possibility of upside in the quarter.

If you remember the prior quarter, Research In Motion management surprised negatively on the operating expense front and disappointed on EPS as well. The "investments" for the future were expected to continue into the August quarter, so there was already a muted expectation coming off of the previous call.

I am a firm believer in the smartphone market segment and have stated previously that I expect it to grow rather dramatically, with the midrange shrinking. That opinion was bolstered a few weeks ago when **Brightpoint** (CELL) management suggested it expects the same thing to happen in the coming years.

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With shares of Research In Motion down about one-third from their highs last June, expectations are clearly negative. However, I see the market as being overly negative at this point, and we very well may see results come in better than expected.

• **Micron Technology** (MU)
The company will report earnings Oct. 1, but as of this writing no time has been set for the conference call. Current consensus estimates are for revenue of $1.55 billion -- up 8% year over year and up 4% quarter over quarter -- and a loss per share of 22 cents.

Based on recent pricing in the memory markets, the company's ability to meet consensus revenue targets will be dependent on bit growth in the quarter, which I think should be sufficient. However, I do think that the company will lose more than 22 cents per share at this point.

As I mentioned last week, the industry needs more capacity reductions in both DRAM and NAND flash. Those are coming along slowly, with weaker-than-expected demand growth due to economic weakness. However, all of that is already priced in to Micron's stock, and it is simply a matter of time before demand overtakes supply and prices increase.

Details of the Cypress Distribution

Next Monday after the close, Cypress will complete the distribution of its holdings in SunPower to Cypress shareholders of record as of Sept. 17. For each share of Cypress people will receive 0.2742 shares of SunPower Class B stock, which will trade under the symbol SPWRB. At this point, the stocks trade on a "when issued" basis under the symbol SPWRV for the B shares and CY-WI for the Cypress shares.

Therefore on Sept. 30, Cypress' stock will be down substantially as demonstrated by the current trading in CY-WI, which closed at $4.90 today. I don't have all of the data yet to determine just how low the valuation is on a price/sales basis, but believe me, it's low. And that's been my point with this stock all along -- a great new product family (PSoC) that should run for years and an amazingly low valuation. Now the company just has to execute!

The Telecom Connection Portfolio

Company Name	Date Initiated	Cost Basis per Share	No. of Shares	Amount Invested	Current Price	% Gain/Loss	IXTC at Buy Date	IXTC Return
Apple AAPL	2/15/06	$100.56	300	$30,168.00	128.71	27.99%	235.36	-8.18%
Alvarion ALVR	2/22/07	$8.98	2,510	$22,538.00	5.97	-33.51%	244.9	-11.76%
Advanced Micro Devices (call options) AMDAZ – 20 contracts	8/29/08	$3.80	2,000	$7,600.00	2.70	-28.95%	245.86	-12.10%
Clearwire CLWR	11/12/07	$13.50	500	$6,750.00	11.50	-14.81%	257.91	-16.21%
Cisco Systems CSCO	3/30/05	$22.51	800	$18,009.00	22.80	1.28%	223.36	-3.25%
Cypress Semiconductor CY	7/10/08	$24.80	2,000	$49,610.00	27.58	11.19%	230.96	-6.44%
Dell (call options) DLYAD – 20 contracts	12/6/07	$6.80	2,000	$13,600.00	0.64	-90.59%	259.97	-16.88%
First Solar FSLR	8/28/08	$263.55	150	$39,533.00	221.8	-15.84%	239.62	-9.82%
Google GOOG	2/9/06	$494.76	75	$37,106.70	435.11	-12.06%	243.87	-11.39%
Level 3 LVLT	6/19/08	$3.76	3,000	$11,280.00	3.03	-19.41%	263.91	-18.12%
Motorola MOT	4/12/06	$23.20	1,000	$23,205.00	7.50	-67.68%	226.48	-4.58%
Netlist NLST	2/14/08	$1.46	3,500	$5,095.00	1.18	-18.94%	232.75	-7.15%
Qualcomm QCOM	8/14/08	$55.02	500	$27,510.00	45.29	-17.68%	256.15	-15.64%
Research In Motion RIMM	11/19/07	$113.82	200	$22,763.75	96.71	-15.03%	247.44	-12.66%
Riverbed Technology RVBD	7/26/07	$32.56	450	$14,654.25	12.39	-61.95%	244.32	-11.55%
SunPower SPWR	2/14/08	$89.70	300	$26,910.00	93.30	4.01%	239.54	-9.78%

(The model portfolio continues on the next page)

Microtune TUNE	2/8/07	$5.23	2,500	$13,075.00	2.85	-45.51%	244.96	-11.78%
Micron (call options) WGYAZ – 125 contracts	8/28/08	$2.26	12,500	$28,250.00	2.05	-9.29%	251.83	-14.19%

The Telecom Connection Portfolio – Performance

Total Average Return	- 27.17%
2008 YTD Return	- 38.70%

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. Sales are taken from the most recent purchase of that stock unless otherwise stated. The 2008 YTD Return figures reflect changes since the beginning of 2008. The Total Average Return figures reflect changes since inception on 8/14/2001.

Nasdaq Telecom Index Performance

	Portfolio Inception	Open Level	Current Level	% Gain/Loss Since Portfolio Inception	2008 YTD Return
Nasdaq Telecom Index (IXTC)	8/14/2001	262.84	216.10	- 17.78%	- 15.39%

At the time of publication, Mr. Faulkner was long CLWR, MU, TUNE, TUNE calls.

To see the full Telecom Connection model portfolio, including closed positions, visit http://www.thestreet.com/k/tc/portfolio.html

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