

Stock of the Month: AudioCodes (AUDC)

Background

AudioCodes (Nasdaq: AUDC) develops enabling technologies and products for the transmission of voice and fax over packet networks (VoIP). AudioCodes markets its technology via both hardware and systems sales. It's one of the few pure-plays in the VoIP market and has been a leader in feature richness and quality for over 15 years in the industry.

offerings. Because AUDC provides a complete system, the firm is winning OEM business. Basically, any time networks running on different protocols need to converge, AUDC can provide value.

Customer ROI: The enterprise, in particular, is looking for cost savings across the board and that's driving demand for VoIP. VoIP is just beginning to drive costs down in the enterprise.



Investment Thesis

Growing Market: While overall telecom spending is slated to grow in single digits over the next couple of years, growth in VoIP is growing much faster and capturing a larger share of overall spending. Industry estimates for VoIP growth is around 20% CAGR over the next 5 years. WiMax rollouts and enterprise spending are driving this growth. Emerging markets are building VoIP networks and MSOs and Cablecos are all looking to roll out voice services as part of triple-play

Particularly in a cost-sensitive economic cycle, firms are looking to reduce costs across the business. AUDC is focused on expanding the customer portfolio but also motivated to continue getting more and more business from existing customers.

Cheap Stock: AUDC is executing in an environment where others are flailing (see APKT). Forex headwinds have created a challenge but the company seems to be managing the cost structure effectively. AUDC has a forward P/E under 10, a P/S just over 1,

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and a PEG Ratio of 0.55. The market has appeared to be pricing in a lot of risk at these low levels. The firm has a sizeable cash position over \$100 million and is generating cash.

Catalysts

ForEx headwinds subsiding: With the recent Fed statement, the US Federal Reserve is getting more serious about fighting inflation and strengthening the dollar. While the dol-

lar has also suffered, the Israeli shekel has been one of the strongest global currencies over the past 2 years. Analysts are looking for the shekel to ease back closer to historical levels. AUDC could see these forex headwinds turn into wind at its back, as the firm would enjoy the benefits of a stronger dollar and weaker shekel.

New wins: AudioCodes made the decision about three years ago to move away from being a pure OEM to going local and building out its service provider business. With over 20 locations around the world, AudioCodes has spent a lot of time working prospects as well as providing high-level service to existing clients with an eye on follow-on business. This local presence is important in winning service provider business and creating demand for AUDC technologies.

Potential Upside: AudioCodes just reported quite good Q2 numbers in an extremely tough environment. Even with an increased stock buyback, the firm

generated cash and earnings and revenue upside. A cheap stock, AudioCodes is positioned to see VoIP business even with a tough macroeconomic backdrop. With a lot of bad news priced into the stock at these levels, the firm may continue to surprise.

Threats to Thesis

Macroeconomic decay: With the NASDAQ down over 15% this year, investors have been wary of telecom in general and

even more so, small caps in the space. Accepted wisdom is that telecom spending will be hit extremely hard in a U.S.-led global recession.

Execution risk: While the company sports leading technologies, it hasn't been the most consistent of performers. The shekel headwinds have not helped either. If something goes wrong in the story and execution worsens, the stock may see additional downside.

AudioCodes (AUDC)

as of 29-Jul-2008

Recent Price	4.17
Market Cap (m)	180
Float	33.2M
% Shares Held by Insiders	27.28%
% Shares Held by Institutions	22.70%
Earnings Per Share	
2006 EPS	0.38
2007 EPS	0.19
2008 EPS	0.39
Revenue Growth 2007	16%
Revenue Growth 2008	13%

AUDIICODES LTD
as of 28-Jul-2008



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Israel Opportunity Investor Portfolio

as of 30-Jul-2008

Ticker	Company Name	Reference Date	Reference Price	Current Price
SILC	Silicom Ltd.	5/27/2008	8.55	5.63
ELOS	Syneron Medical	4/28/2008	15.11	15.03
ESLT	Elbit Systems	3/30/2008	56.32	55.02
CKSW	ClickSoftware	12/26/2007	3.68	2.34
GILT	Gilat Satellite Networks	11/27/2007	10.51	10.84
NICE	Nice Systems	11/27/2007	32.27	29.98
DOX	Amdocs	11/27/2007	31.38	30.36
CHKP	Check Point Software Tech	11/27/2007	20.82	23.50
CMVT.PK	Comverse Technology	11/27/2007	15.75	15.17
EMITF	Elbit Medical Imaging	11/27/2007	54.53	32.00
ALVR	Alvarion	11/27/2007	9.29	6.55
WILC	G. Willi-Food International	11/27/2007	6.50	2.93
VRNT.PK	Verint Systems	11/27/2007	17.30	21.25
ORA	Ormat Technologies	11/27/2007	47.22	46.46
BPHX	BluePhoenix Solutions	6/29/2008	4.99	4.69
TEVA	Teva Pharmaceuticals	7/30/2008	44.58	44.58
AUDC	AudioCodes	7/30/2008	4.17	4.17

Companies chosen for the Israel Opportunity Investor Portfolio undergo a variety of filters aimed to screen for potential capital appreciation. Filters include mainly fundamental screens but may also

include quantitative analysis. Information about each company is received from sources believed to be reliable. Related Persons may hold positions in some or all of the stocks mentioned in this report.

IOI Portfolio Update

July was a tough month for the IOI portfolio, as global markets continued to drop because of ongoing skittishness in the financial sector and less than stellar earnings, and significant selling pressure hit the IOI small-cap stocks. We are removing both Zoran (Nasdaq: ZRAN) and Aladdin Knowledge Systems (Nasdaq: ALDN) from the portfolio. Both had disappointing earnings reports and showed little in the way of improved outlook looking ahead. We are also putting G. Willi-Food International (Nasdaq: WILC), Silicom (Nasdaq: SILC), and ClickSoftware (Nasdaq: CKSW) under review. We are adding both Teva Pharmaceuticals (Nasdaq: TEVA) and AudioCodes (Nasdaq: AUDC) to our portfolio. See analysis above.

Shares in Amdocs (NYSE: DOX) withstood the selling pressure and moved up more than 3% as the company released a strong earnings report, and raised guidance for the rest of '08. The company

reported revenue growth over 15% from last year's fiscal 3rd quarter.

Shares in WiMax provider Alvarion (Nasdaq: ALVR) dropped slightly over the month but got a big boost on the back of their earnings report. The company reported a 21% increase in revenues over Q2 '07. The report also stated that current customers are expanding their networks, both booking and the pipeline of new business are strong. They raised their full year revenue target to the upper end of the range of \$275 to \$300 million.

Shares in security giant Check Point Software (Nasdaq: CHKP) also managed to hold steady in the face of the market sell-off. The company reported strong earnings and upped their numbers for the rest of '08. For investors, these results helped allay fears that a slowing economy could hamper corporate IT and security spending.

Investor Insight: Daniel Goldstein, Prisma

Tell us about Prisma?

Daniel Goldstein, Head of International Sales, Prisma: Prisma is one of the largest investment houses in Israel. We are a wholly-owned subsidiary of Markstone Capital, a U.S. private equity fund set up in order to invest in "old economy" opportunities in Israel. We currently manage approximately \$15 billion across our provident and mutual funds, ETFs and portfolio management businesses. We also operate one of the largest brokerages in the local market.

We pride ourselves on the fact that we have no conflicts of interest as we do not underwrite equities or act as principals in bond trading. We are a full service operation servicing private clients and institutional customers. We work with many large pension funds, hedge funds, asset managers as well as prime/broker dealers.

As a large local Israeli firm, can you tell us how you view the local economy?

DG: The Israeli economy has never experienced such a strong and sustained period of growth as it has over the last five years. The stock market has gone up by over 250% over that period, the shekel is one of the strongest currencies in the world, unemployment is historically low, and the FTSE raised Israel to developed market status with MSCI also discussing doing the same. Israel is poised to become a member of the OECD.

The potential change in OECD status has become a point of debate in the local market. Is it better to be a medium fish in a big pond or a tiny fish in a huge

pond? The debate will undoubtedly continue. The banks have suffered because of some exposure to the global credit crisis but the economy has been fairly resilient to the world's woes even though we have had to endure increasing commodity and fuel prices like the rest of the world. This has had an effect on inflation, which the Bank of Israel is attempting to control by increasing interest rates. Rates currently sit at 4%.

What about the impact of the Shekel?

DG: The impact of the shekel is having a very mixed impact on the economy. It is making imports cheaper and our exports more expensive. This is having a positive effect on the CPI as some of the commodity increases have been neutralized, but a negative impact on the cost basis of some companies that have income in USD but expenses in shekel. It is also likely to affect the tourist industry for Americans and Europeans, as Israel is now quite expensive. The shekel has, however, weakened of late against the dollar and is likely to continue this trend between now and the end of the year, which will be as much about the dollar strengthening as the shekel weakening.

Can you tell us about some companies that you're investing in?

DG: The main talking point with regard to Israeli companies that trade in the US has to be Teva (Nasdaq:TEVA). Teva has just announced its takeover of Barr for \$7.5 billion making it firmly the largest maker of generic drugs in the world. In the U.S., 1 in 15 prescriptions are for a Teva product. With a presence in 60 countries and 28,000 employees globally,



Daniel is the Head of International Sales at Prisma. He moved to Israel in July 2007 from London with his wife and three children. Previously, Daniel ran a mortgage and property business, and before that he was part of a team who established a fund supermarket platform for Old Mutual Group called Selestia.

Teva is truly a global operation. The business has a broad product portfolio and a huge pipeline. This, coupled with the rationalization of the merger with Barr, should give the company a very bright future. Most analysts have a strong buy on Teva and believe that it is a really well run, innovative and profitable company.

What else are you looking at?

DG: Another stock that's contributed recently to the moves in the TA-25 is Israel Chemicals. Israel Chemicals hold the license to mine the minerals from the Dead Sea. ICL has participated in the increase in the price of potash from approximately \$200 a ton to \$1000 a ton. We believe that the years 2008 and 2009 will be good ones for Israel Chemicals,

due to the combination of the ability to sell quantities in excess of Israel Chemical's production capacity (by reducing inventories) and the high price of phosphates. Our valuation model assumes that in the said years, the company will sell an aggregate of almost 900 thousand tons in excess of its production capacity, and these sales will generate revenues of almost \$750 million. We believe that the shares

may be volatile at times but that there is still money to be made here.

How do you see the investments of foreign institutions influencing the local market?

DG: Foreign Institutions have a large impact on the Israeli market, currently amounting to 25% of the local market. The Tel Aviv Stock Exchange plans to increase this to 40% via cooperation agree-

ments in place with foreign markets, like NASDAQ, the London Stock Exchange and a brokerage in Japan. Israel's position in the world is likely to change going forward but it is undoubtedly a very exciting place – whether it's the involvement of companies like Microsoft and Berkshire Hathaway or the invention of an electric car by Project Better Place.

Thanks.

Company Uncovered: Elron (ELRN)

IOI is featuring Elron as part of this month's Company Uncovered feature. A pioneer in Israeli high tech, Elron manages both public and private company investments. We'll drill down into Elron's private company investments as part of Israel Ingenuity later this issue.

Tell us about Elron (Nasdaq: ELRN)?

Doron Birger, CEO: For the last 46 years, Elron has been a major power in Israeli high-tech. We're traded both on the TASE [ed. the Tel Aviv Stock Exchange] and NASDAQ. We're not a traditional VC firm, but an active holding company investing in Israeli startups, in all stages of development, who can be eventual leaders in their fields. We have 30 companies in the portfolio, some which are already public while the majority are still privately held.

We have very good access to Israeli deal flow given our long history in Israeli high tech. Our agreement with Rafael [ed. one of Israel's largest defense contractors] is a value differentiator. We are equal partners with Rafael in a joint firm to commercialize any defense technology developed by Rafael. This means we have

access to the products of tens of billions of dollars invested in this enterprise by the Israeli government.

We are also part of the IDB group, which has 50% ownership. We are essentially like the technology arm of IDB.

What's the investment mandate? What's your strategy?

DB: We look to invest in firms that can become leaders in their fields with broad technologies, IP barriers and growing global products with strong management team. We structure our investments with the intention to be a major shareholder in our portfolio companies, consisting of between a 20%-50% ownership stake, although there are examples where our actual holdings vary.

We call ourselves 'builders' as much as we are investors. Because we are not a traditional VC firm, we are one of a few firms that grow with our companies as they mature, beyond any particular growth or funding milestone.

What does it mean to be a 'builder'?

DB: We are very dedicated to

providing long-term support for our companies. We take a very hands-on role in our portfolio companies using our experience in building firms, commercializing them and taking them public and beyond. Given our history and network, we work to identify strategic partners, build management teams, and structure transactions via IPOs and restructurings.

Can you give us an example of some holdings?

DB: Let's start with Given Imaging (Nasdaq:GIVN). We've been involved since before the IPO and we can stay involved with the company for many years after the IPO.

In our public company portfolio we own shares in leading Israeli technology firms like Zoran (Nasdaq:ZRAN), Elbit Systems (Nasdaq:ESLT) and Partner Communications (Nasdaq:PTNR),

What about exits?

DB: We have completed exits in total of over \$2 billion with \$800m back to Elron. We are probably the largest investor in Israeli high tech with \$50m-\$100m dollars in Israeli companies.

What does Elron's management structure look like?

DB: We don't maintain a big headquarters – we are less than 30 people. Each of us has lots of connections and experience in his space.

Can you talk to us about Elron's financial position?

DB: Financially, Elron is very strong with over \$300 million in assets we can tap. We have a lot of assets we can leverage with access to additional cash if we need, allowing us to participate in very large transactions with credit facilities we are currently not fully using.

We have distributed over \$200 million in cash dividends over the past 7-8 years, equivalent to \$8/share.

Do you keep cash on your balance sheet?

DB: We have about \$11 million with borrowing facilities totally about \$24 million and a lot of

unused borrowing facilities. Access to funds is practically not an issue.

One thing about our balance sheet I'd like to explain is that our quarterly P&L reflects write-downs of investments. We depreciate the value of our holdings and we can only book a gain when we have an exit. Since we are not doing early-stage exits and look to grow for long term, we typically see these quarterly write-offs.

The value of our public company holdings is about \$177 million and our private company holdings approximate \$250 million. That means, today, Elron is traded at the value of its public company portfolio less our debt and for about \$15 million, an investor can buy our entire private portfolio.

Also, our private companies are getting quite mature in their businesses and are beginning to ramp revenues. We see upside

ELRON (Nasdaq: ELRN)

as of 29-Jul-2008

Recent Price	7.17
Market Cap (m)	213
Float	13.69M
% Shares Held by Insiders	60.4%
% Shares Held by Institutions	2.5%
Earnings Per Share	
2006 EPS	\$0.10
2007 EPS	\$(1.25)
2008 EPS	NA*
Revenue Growth 2007	NA*
Revenue Growth 2008	NA*

* Because Elron is a holding company, we don't use EPS.

ELRON ELECT IND LTD
as of 29-Jul-2008



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potential in many of our companies but also see that we're close to providing real value on the business side.

Would you look to invest in public companies hurt by the current market?

DB: Because we are not a VC, we can invest in public firms. Is it practical that we do it over the next year? Probably not.

Although we have nothing on the table, if we encountered a deal like was done with Lumines, it could be done by Elron.

Israel Ingenuity: Elron, Part II

We're continuing with Elron as the firm speaks about their portfolio of private companies. Together with RDC, Elron has one of the most interesting private portfolios in Israel.

Can you tell us about your portfolio of private company investments?

DB: Medingo: a 51% Elron and RDC company. This firm was started in the Rafael Development Corporation (RDC) in 1995. It's a miniature pump, like a small patch, for insulin delivery designed for patients with insulin dependent type 1 Diabetes, who receive insulin treatments more than ten times per day. We leave the patch on for 3 days, there are no tubes, and replace every 3 days. It can be put anywhere. It can go in water, even hot water.

It's portable, convenient and cheap. The whole cost per year to the medical system is about \$2500 and Medingo sees 70% gross margins or higher. It's a \$1+ billion market. The closest peer Insulet (Nasdaq:PODD) has a market cap of \$400m.

If it's a good company with good products, we could potentially act like a private equity investor. We could take a firm private or keep it public – whatever we think would makes sense.

We are focused on working through a few exits from now until the end of 2009. We probably don't need 30 companies in our portfolio and we could use being a bit smaller and focused. I think we'd be more efficient to be spread over 20 firms with a tight focus on medical devices and cleantech and probably scale out of semis.

We have smaller, cheaper, and a more advanced product ready to go by the end of 2009. We would like to see a direct sales model, like Given Imaging employs, which means we need a sales team and product educators, the focal point for distribution. We need to establish a distribution infrastructure. Hopefully, we will be a publicly traded company with big competitors like J&J, Medtronic, and Roche. This is a platform technology that can be used to deliver different agents to the body continuously, like pain applications and cancer treatment.

BrainsGate: a 28% Elron company. We've invested along with Pitango and Boston Scientific in this firm that develops a minimally invasive neurostimulation platform. Via stimulation, we can increase blood flow to brain to treat ischemic stroke within 24 hours post stroke while other treatments need to be administered within the first 4 hours.

We have more than 60 human trial results and will go through



Mr. Birger has served as President and Chief Executive Officer at Elron since August 2002, President since September 2001, Chief Financial Officer from 1994 to May 2002 and Corporate Secretary from 1994 to September 2001. Mr. Birger is Chairman of ChipX as well as a director on Given Imaging, Galil Medical, RDC, Ellara, Teledata, Wavion and NuLens.

FDA approval. We're looking at 2011 to be approved. If our technology proves to be able to keep patients independent after a stroke, this is huge. This has a market potential of over \$10 billion.

The platform also enables us to treat vascular dementia, a chronic treatment, and we think we can slowdown deterioration of the brain. Here, we're just beginning human trials.

Lastly, we have the ability to open the blood-brain barrier to allow delivery of drugs to the brain and take out isomer diseases, like Alzheimer's. We are currently in animal trials for this application. We'll probably see larger fund raising rounds. At the World Economic Forum in

Davos, BrainsGate was chosen as one of top 40 companies in the world and the RedHerring magazine sees us in the top 100.

NuLens: a 34% Elron company. This firm has developed the first real accommodating intraocular lens for patient implant. We have the capability to provide over 10 diopters of power versus 1-2 today. The cataract market is over \$1 billion and affects over 14 million people. Bausch & Lomb acquired a competitor for something we estimate to be in the range of hundreds of millions of dollars. Warburg Pincus acquired B&L and is also major holder in NuLens. We've got 10 people in clinical trials with our lenses in their eyes and the results good. We're looking toward 2011 for launch although we may be able to start selling in Europe by 2010.

Starling: a 50% Elron and RDC company. They've developed a revolutionary antenna enabling competitively priced airborne broadband. We see applications for 3 markets:

- 1) Commercial airliners
- 2) biz jets
- 3) military planes

The product is finished. We've got antennae flying and hopefully this year, we should start seeing revenues. Starling is publicly traded in Israel.

3DV Systems: 36% Elron and RDC company. This firm has developed breakthrough-imaging technology packed into small web camera that captures 3 dimensions. With the camera, you've got state-of-the-art gesture recognition for controlling video games, PCs and other appliances. With a street price of \$100, it can be sold into video

game console manufacturers. The product is completed and we hope to see first orders from Microsoft Xbox or Sony Playstation or from game publishers later this year. Think of what you could do with Apple Computers (Nasdaq:AAPL) to evolve the interface on PC to make it closer to the iPhone? Kleiner Perkins made their only Israeli investment via this company.

Atlantium: a 33% Elron company. This company has developed a hydro-optic disinfection (HOD) solution for treatment of water. The technology uses UV light to deactivate microbes and waterborne pathogens. We're starting to sell this system into food and beverage companies like Coke and Pepsi. We see a strong market in fish farms because they also require very clean water. We should do about \$5 million in revs for 2008 and are growing nicely. It's a very promising company and was also rated by the RedHerring as a top 100 company.

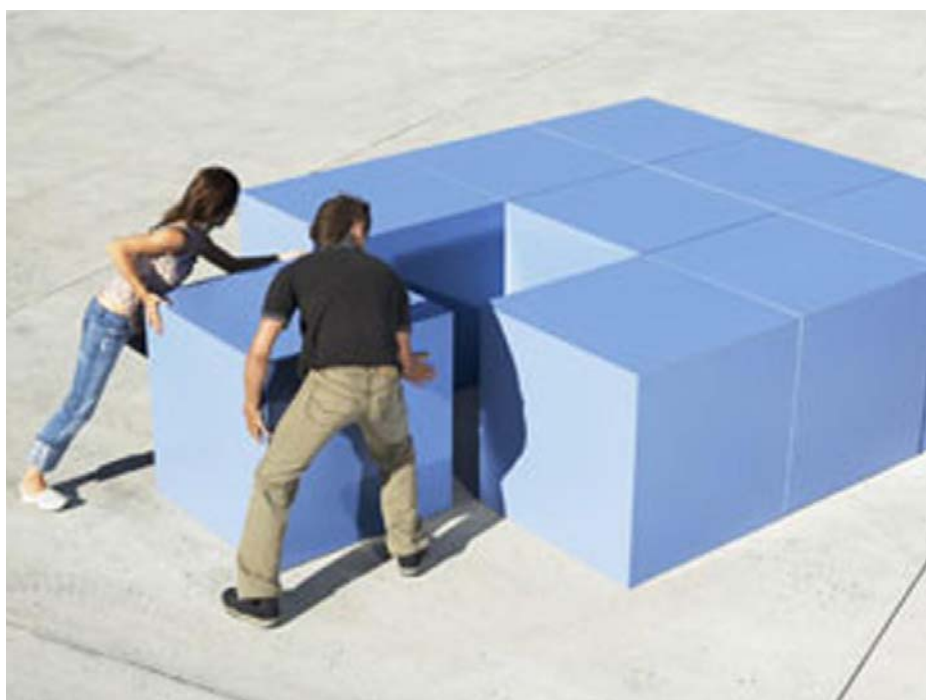
What can go wrong in the Elron story?

DB: We are not new company and we've been around for a long time, over 20 years on NASDAQ. There are not too many companies listed on NASDAQ that can say that they've been around for 46 years. We see a few of our portfolio companies succeed in a big way, while others lesser so. We've got deep penetration into Rafael, which carries no value on our balance sheet, but should provide a good sense of confidence for the future. We are seeing good deal flow both because of Rafael and beyond. Our vision is to be focused on fewer firms in our group going forward. VCs continue to seed new companies and we continue to see new companies being formed. I don't believe we'll have an issue with growth opportunities or deal flow going forward.

What about cash management for private companies? Does your portfolio have exposure to subprime cash instruments?

DB: No, our firms didn't invest in these vehicles.

Thanks.



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