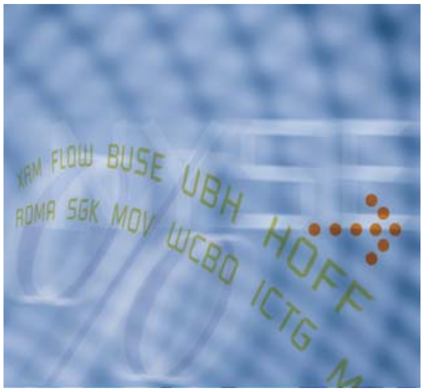

EquityIncentive
EIA ANALYTICS

Issue Commentary

22 March 2010

Category-Creating Research = Gradient Unique Signals

Since the launch of Gradient Analytics' Equity Incentive Analytics (EIA) service in 2005, we have consistently provided money managers with one-of-a-kind actionable ideas. Built on the foundation of co-founder Dr. Carr Bettis' category-creating academic and modeling research identifying normative (and abnormal) executive option-exercise activity, EIA expanded the scope of its research to incorporate additional executive behavior signals not covered by any other research service.

Central to Gradient's observations on executive behavior is that most executives' management of their equity wealth is impounded with too much noise to draw useful inferences about possible motives. On the other hand, a discrete set of abnormal executive behaviors Gradient has followed appear to be instructive about future share-price performance at the related firms.

Gradient's one-of-a-kind executive-behavior signals have a robust performance record, have withstood the test of time, and provide our clients with actionable ideas in all cycles of the market. In this *Issue Commentary* we review the historical performance of these behavioral signals, provide examples of our recent work for each signal as well as a sample of ideas our analysts are following.

Negative Signals

Early Exercise
Page 2

Our model describes normal option-exercise activity by Section 16 filers. Abnormal activity precedes on-average share-price underperformance.

Aggressive Rule 10b5-1
Page 10

Trading plans that appear to be aggressively designed precede larger-than-average share-price underperformance.

Hedging
Page 15

Research shows that hedging transactions by Section 16 filers precedes on-average underperformance.

Positive Signal

Exercise and Hold
Page 4

The rare instances in which Section 16 filers exercise options and do not sell the acquired shares precede on-average share-price outperformance.

Performance Summary[1]

Grade	Excess Return	Count	Period
Exercise-and-hold	11.4%	72	04/01/07–03/05/10
D	-4.7%	353	02/01/05–03/05/10
F	-9.5%	44	02/01/05–03/05/10

[1] Returns are measured over rolling six-month fixed-holding periods and annualized. Excess return defined relative to one of 11 comparable IBES sectors and one of four market-capitalization categories. Exercise-and-hold is a positive recommendation.

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Early Exercise Signals: Sign of a Bear in the Woods?

EARLY EXERCISE

Underlying our research reports on "early-exercise" behavior are Gradient's proprietary quantitative models. Our modeling includes a utility-maximizing option-valuation model that evaluates whether exercise decisions of optionees are unusually early (or late) relative to the model's forecast. In forecasting the option-exercise decisions of option holders, academic evidence and our models establish a clear relationship between the timing of option-exercise decisions by top managers and future earnings misses and hits. They also show a relationship between earnings-announcement-period abnormal returns, earnings/accruals management, and long-term abnormal stock returns.

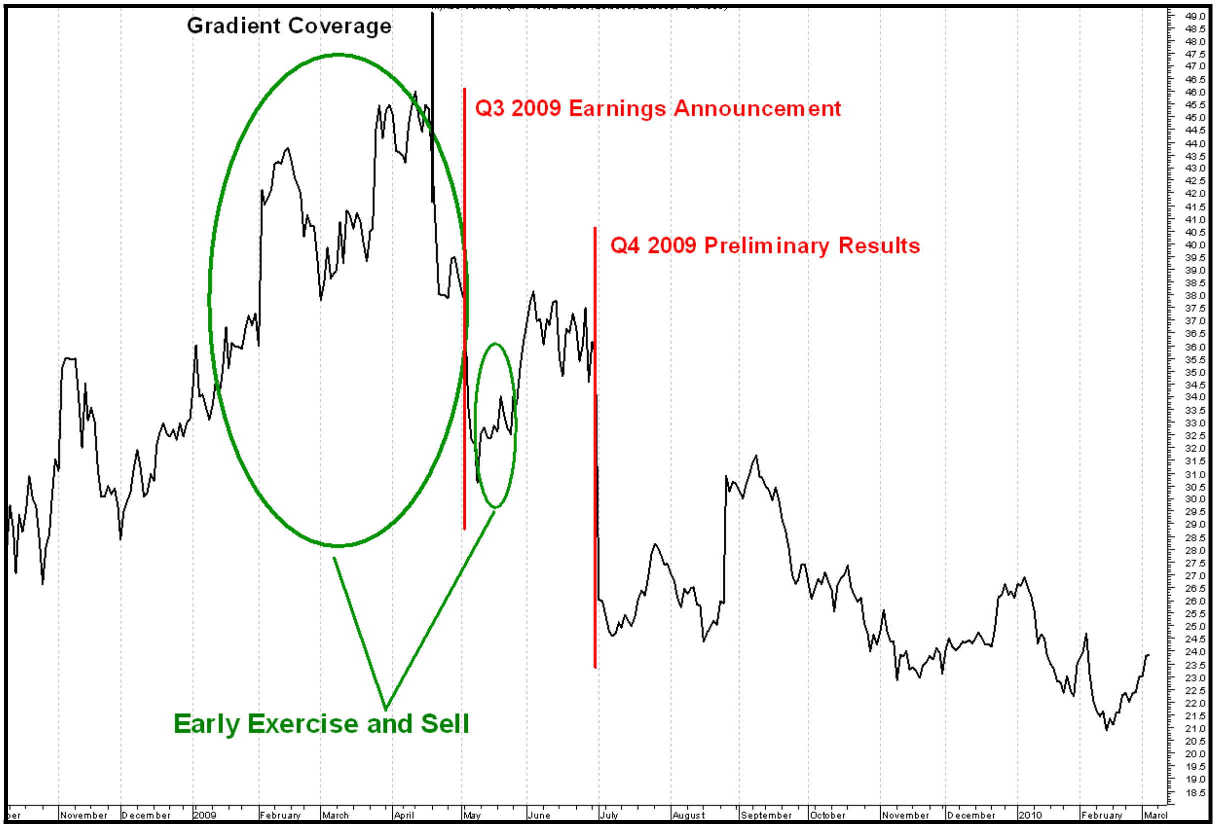
MYRIAD GENETICS INC. (MYGN)

Gradient initiated coverage on MYGN with a grade of D on 04/20/09 after 12 Section 16 filers exercised 549,056 options and sold 488,922 shares. At exercise, the options were deep in the money, with weighted-average profits of nearly 575% in H1 2009. Excluding (including) options nearing expiration, these exercises occurred one year (3.8 months) earlier than predicted by our model.

Our level of conviction was further amplified by the size and consistency of excess returns following similar exercise-and-sale activity occurring in six prior quarters (since CY2000). Shares decreased by a weighted-average of 32.4% in the six months following those earlier exercise-and-sale decisions, and negative returns were realized in five of the six periods.

(See chart, **MYGN Early Exercise Coverage and Share-Price Performance**, *next page*)

Chart 1. MYGN Early Exercise Coverage and Share-Price Performance



MYGN shares declined at two discrete points during our coverage. First, the stock began falling after the conclusion of Q3 FY2009, then fell further on the release of those results on 05/04/09. Of note, Q3 revenues fell short of the sell-side consensus ($87.5 million–$90 million). Second, the release of preliminary Q4 and FY2009 results (on 06/30/09) sent shares into another tailspin. This time management lowered its molecular diagnostic revenue estimate for FY2009 to $326 million versus prior guidance of $330 million and a consensus estimate of $336.8 million. The company also revised its forecast for Q4 revenues to approximately $86 million versus a consensus expectation of $91.6 million. Together, these two misses were sufficient to drive shares down 42.5% during our coverage period.

Gradient moved MYGN from active coverage on 07/02/09.

Exercise-and-Hold: Anticipating the Bounce

EXERCISE-AND-HOLD BEHAVIOR

Most executive option exercises are followed by a sale of the converted shares. This is because of the risk associated with exercise-and-hold transactions—e.g. an executive's possession of imperfect information, commitment of personal wealth to acquire shares, and the related taxes, etc. Our works suggests that anomalous exercise-and hold behavior may be associated with either private information and/or an extremely bullish sentiment.

Those embarking on the apparently risky wealth-creation strategy involving exercise-and-hold transactions may benefit from reduced ordinary income tax obligations when exercises are well-timed. If the acquired shares are not sold for 12 months, any appreciation from the date of exercise to the sale date is treated as long-term gains for tax purposes. In contrast, with a simultaneous exercise-and-sell, the difference between the exercise price and the market value of shares at exercise date is treated as ordinary income for tax purposes. [2]

The tax benefit of an exercise-and-hold transaction is likely to be more actionable to executives in possession of private information, as options may then be exercised after negative news (to minimize current tax at 35%) and before positive news (to shift gains to 20% long-term capital-gains treatment). Executive bullishness about the company's future performance, (perhaps in concert with a fall in share price) may also represent an exercise-and-hold event of significance to a firm's future performance.

NOTE: In the period before the implementation of SoX, we identified the opportunistic practice of "exercise backdating," where executives may have selected favorable "look-back" periods to exercise options and minimize ordinary income tax obligations (while shares were planned to be held for the subsequent year).[3]

NBTY INC. (NTY)

We initiated coverage on NTY on 06/24/09 as a result of a large-volume exercise-and-hold transaction involving CEO Scott Rudolph. From a behavioral perspective, our view was that Randolph's exercise-and-hold decision and prior history of well-timed investments in NTY was a signal of expectations that "margins and earnings (were) likely to rebound strongly."

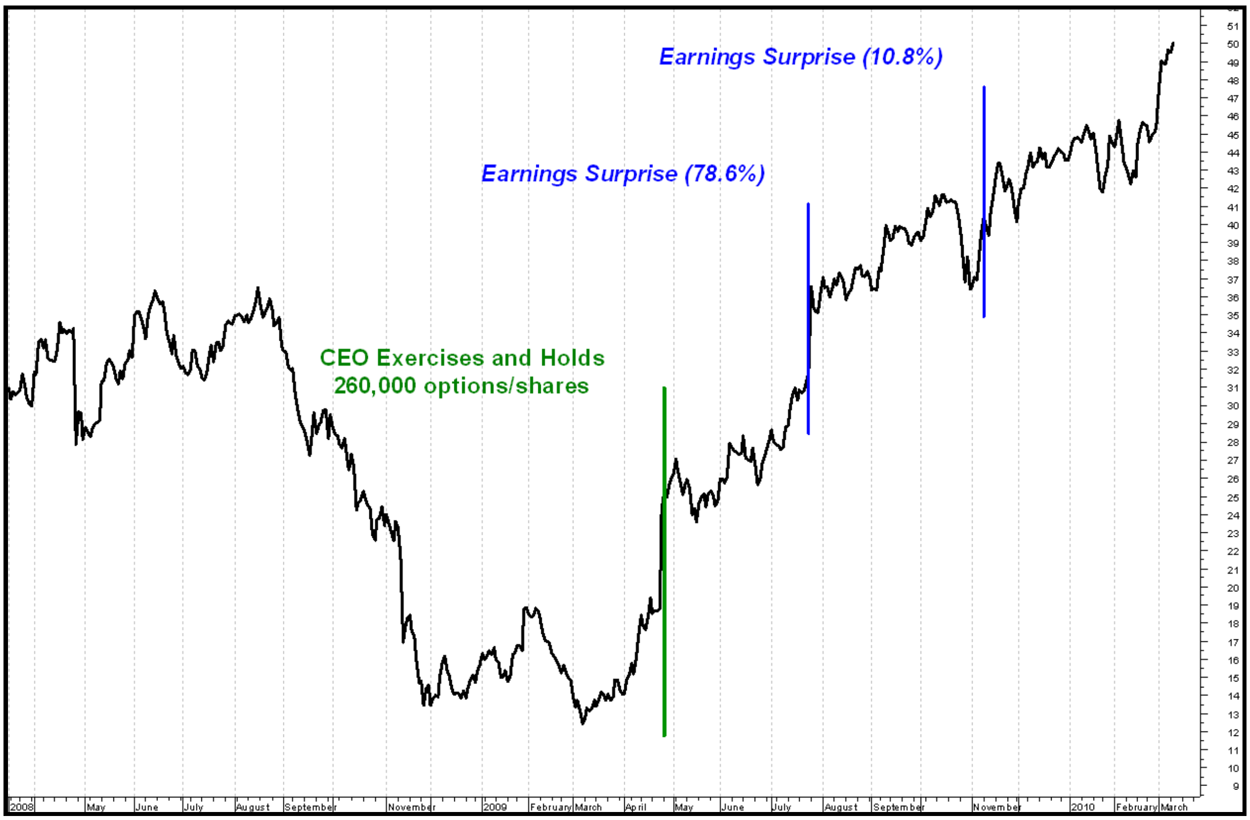
Earlier, on 04/27/09, following NTY's release of fiscal Q2 earnings, Rudolph exercised 260,000 options and held all of the acquired shares. The decision to hold the shares is noteworthy for several reasons. For one, NTY shares

[2] As of tax year 2006, the highest marginal tax rate for ordinary income and short-term capital gains is 35.0%. Long-term capital gains tax is 15.0% for taxpayers in the 25%, 28%, and 35% tax brackets. Given the tax structure of the IRS, if executives are highly confident in their firm's share-price performance, they have financial incentive to exercise options at a relative low, minimizing gains at exercise subject to ordinary income tax. Shares can then be held for 12 months and sold subject to long-term capital gains tax (15%).

[3] See our Library of work on exercise backdating at http://www.earningsquality.com/eiaExerciseBackdating.do?action=View&menu=eiaExerciseBackdating.

appreciated 28.6% between the announcement of Q2 earnings (04/23/09) and Rudolph's exercise decision. Notwithstanding this increase, the CEO acquired shares from options (which were not nearing expiration) and did not sell of any shares. Additionally, his prior share-acquisition activity (including exercise-and-hold transactions and open-market purchases) has been very well-timed—as have his share sales.

Chart 2. NTY Exercise-and-Hold Coverage



Consistent with expectations, fiscal Q4 gross margin (operating margin) rose 176 bps (755 bps) YOY to 45.6% (18.2%)—marking the highest levels for either metric since Q3 FY2008. Management attributed the increase to higher operating leverage and more efficient supply-chain management (Q4 FY2009 conference call). In addition, an increase in market share also appears to have aided the firm's gross margin expansion. According to other disclosures made on the Q4 FY2009 analyst call, the food, drug, and mass-channels nutritional supplements market grew 11% YOY, while NTY's Wholesale brand category increased by 13.6% over the same period. This allowed the company to generate record quarterly revenues of $674.1 million (a 12.1% increase YOY) and yielded improved economies of scale in the process. As a result, operating margins were boosted by reduced SG&A costs as a percentage of revenues. In fiscal Q4, SG&A costs were 27.4% of quarterly revenues, down 580 bps from Q4 FY2008 and the lowest level for this metric over at least the past five years.

We discontinued coverage of NTY on 11/18/09 after shares had appreciated 69.4% on an absolute basis (45.4% relative to the S&P 500).

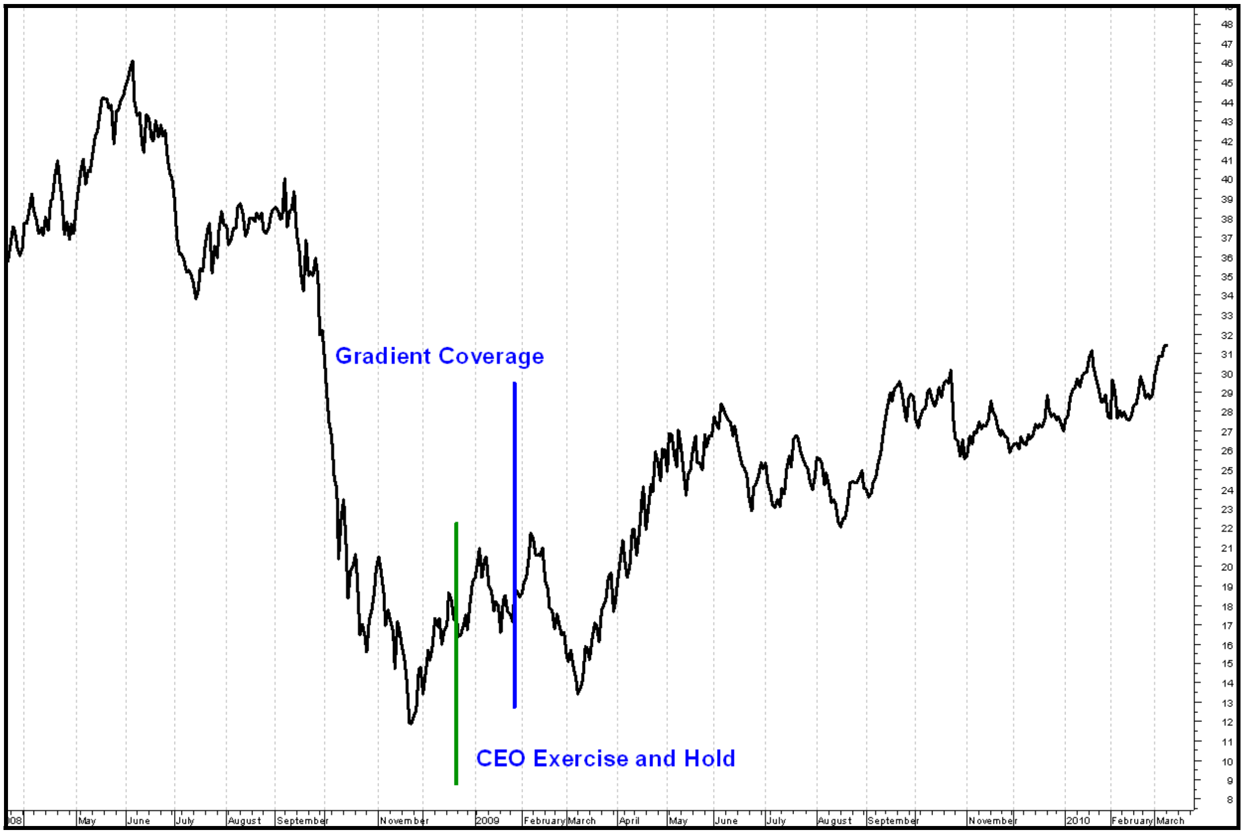
WESCO INTERNATIONAL INC. (WCC)

Shortly after WCC Chairman and CEO Roy Haley acquired 200,000 shares by exercise on 12/19/08, we initialed coverage (01/28/09). In addition to the anomalous exercise activity, we noted Haley's history of well-timed trades: both prior exercise-and-hold decisions and early-exercise-and-sale decisions. Additionally, our coverage initiation observed the firm's abnormally low (and arguably irrational) valuation compared both to its peers and its own historical valuation norms.

Haley's exercise (and hold) of 200,000 options (shares) was counter to normative behavior. In addition to the risks assumed by holding shares, Haley also had to pay the cost of the exercise and the related income taxes (at the marginal rate for ordinary income). We estimated if Haley had sold the shares he would have realized proceeds of approximately $3.5 million (based on the close price on the date of exercise), resulting in a pretax profit of $2.3 million. Instead of selling, he incurred costs related to the exercise and taxes which were estimated to be well in excess of $1.0 million.

(See chart, **WCC Exercise-and-Hold Coverage**, *next page*)

Chart 3. WCC Exercise-and-Hold Coverage



WCC—like others in the space—faced continuing challenges in 2009, as sales declined 25.4% compared to 2008. However, the company made significant operational progress. First, it generated almost $280 million in free cash flow, a record for the firm and 13.9% above free cash flow generated in 2008. Additionally, WCC paid down its total debt balance by $292 million over the course of the year—down 27.7% from the prior year (to $762 million from $1.14 billion). Finally, the firm completed several cost-reduction programs in 2009, which resulted in $140 million in cost savings. Thus despite a choppy earnings record, management's operational adjustments appear to have been favorably received by the market.

For Haley, the value of his shares appreciated and the tax treatment on the gains for shares held over the year are noteworthy. Based on a 12/21/09 closing price, the value of the options converted to shares a year earlier increased an additional $2.2 million. Moreover this pretax profit—now subject to capital gains rather than ordinary income tax—reduced his potential tax obligation on this gain by over $450,000.

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We discontinued coverage of WCC on 02/02/10. Consistent with our expectations, shares of WCC increased 61.8% on an absolute basis (31.1% relative to the DJ Industrial Index).

MICROCHIP TECHNOLOGY INC (MCHP)—CURRENT IDEA

A large exercise-and-hold transaction by CEO Steve Sanghi in February 2010 materially increased his exposure to MCHP's future share-price performance. In two transactions (executed on 02/08/10 and 02/16/10), Sanghi exercised 247,500 options and held all of the acquired shares. Using MCHP's closing prices on the date of each respective transaction, we calculate that the 247,500 acquired shares carried an aggregate market value of $6.5 million. Further, Sanghi incurred $5.8 million ($264,416) in exercise costs (taxes) to acquire the shares.

Sanghi's transactions appear abnormal on two counts: (1) Sanghi chose not to realize $755,475 in profits at the date of the exercise and (2) he invested an estimated $6.1 million in cash to convert and hold these shares.

The scheduled expiration on 04/14/10 for all 247,500 options obviously motivated the exercise decision. However, it fails to explain why the CEO chose to hold all of the acquired shares. In our experience with exercise-and-hold activity, we typically see a majority of these transactions occur near 52-week lows or following a material decline in company stock price. Timing activity in this fashion would lower executives' ordinary income tax obligations and maximize future profits, assuming the share price rises and the executive intends to hold the shares for at least 12 months from the exercise-and-hold decision. However, in the case of MCHP, Sanghi executed his 02/08/10 (02/16/10) exercise-and-hold decision just 12.2% (8.0%) off the firm's 52-week high established on 12/31/10.

(See chart, **MCHP Exercise-and-Hold Coverage**, *next page*)

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Chart 4. MCHP Exercise-and-Hold Coverage

We believe that two of the more likely explanations for Sanghi's exercise-and-hold decision are that (1) he anticipates that the acquisition of SSTI will be accretive to earnings and/or (2) he believes the firm is undervalued given the potential of the combined entity. Furthermore, this decision would only be rational if he believes that shares are likely to trade at a sufficiently higher price to compensate him for taking on the additional risk associated with raising his equity stake in the firm.

Additionally, his past behavior reveals the possible existence of a trading strategy in which he acquires shares via option exercise when share prices are perceived to be below their intrinsic value and then sells after a period of appreciation. Exercise-and-hold transactions where the volume of securities exceeded the average (149,270) for the 29 total decisions had both a higher win/loss ratio and higher returns over the next year. Specifically, Sanghi exercised a total of 3.4 million (or more than two-thirds of all 5.1 million options subject to exercise-and-hold activity) in 11 separate transactions. MCHP shares appreciated following seven out of the 11 (63.6% win/loss ratio) over the next 12 months. In addition, shares increased 32.3% on a weighted-average basis in the following 12-month period. This performance handily surpasses the overall market return for the matching intervals.

Aggressive 10b5-1 Sales: "Safe Harbor" From an Impending Storm

AGGRESSIVE 10B5-1 SALES

Since 2006 we have examined instances in which our analysis suggests that the use of Rule 10b5-1 trading plans by executives appears aggressive. Building on the academic evidence which indicates executives who trade under 10b5-1 plans obtain larger profits than in periods before the Rule, and larger than peers trading outside of such plans,[4] we have focused on what we believe are abnormal subsets within the 10b5-1 trading group.

Among the characteristics we look for in an aggressive use of the Rule are:

- Plans of relatively short duration (=>12 months), particularly when they involve significant divestitures of beneficial ownership.
- Asymmetric volume-to-time sell-through of plans, which results in planned sales occurring at an accelerated rate compared to the plan's term.
- The apparent use of price triggers, which accelerate selling at what appear to be the executives' estimates of the upper bounds of a firm's share price.
- Multiple plan use, or sequential use of plans (particularly if one plan was sold though earlier than its term and is followed by another plan).
- Plans which, if completed, would represent a material reduction in an executive's beneficial ownership (amounting to a significant reduction in the link between executive wealth and shareholder interests).

As we have noted throughout our coverage of Rule 10b5-1 plans, disclosures about the use of the rule are inconsistent (at best) and frequently unavailable. Anecdotally, for some firms, disclosures about the size, term, and other characteristics of the plan (regular selling patterns, price triggers, etc.) have fallen below the standard used in earlier periods. A declining transparency standard is another flag of interest to our analysts, particularly if prior uses of rule plans appeared to have been well-timed. Generally, however, the absence of required disclosures about the use of the rule makes a market-wide analysis of plan usage very challenging. In this regard, our subjective evaluations of aggressive rule use provide observations on otherwise overlooked expressions of executive behavior.

OSI PHARMACEUTICALS INC. (OSIP)

Gradient initiated coverage of OSI Pharmaceuticals Inc. (OSIP) (09/03/08), maker of Tarceva, on a heightened risk of future share-price underperformance based on our analysis of executives' apparent aggressive use of Rule 10b5-1. Seven OSIP executives and directors had sold a total of 140,966 shares worth $6.9 million

[4] Jagolinzer, Alan D. "An analysis of insiders' information-based trade within the SEC Rule 10b5-1 safe harbor." (Stanford University, Graduate School Business, January 2005). Jagolinzer cautions against "generalizing the results" with respect to the trading activity that occurs within "nondisclosure firms" while also noting that his results "may understate the extent of 10b5-1 information-based trade by insiders at nondisclosure firms," due to the reduced ability to monitor compliance. Jagolinzer also observes that generally, "participating insiders' sales volume is positively associated with abnormal returns and is greater before 'bad news' earnings announcements than before 'good news' earnings announcements."

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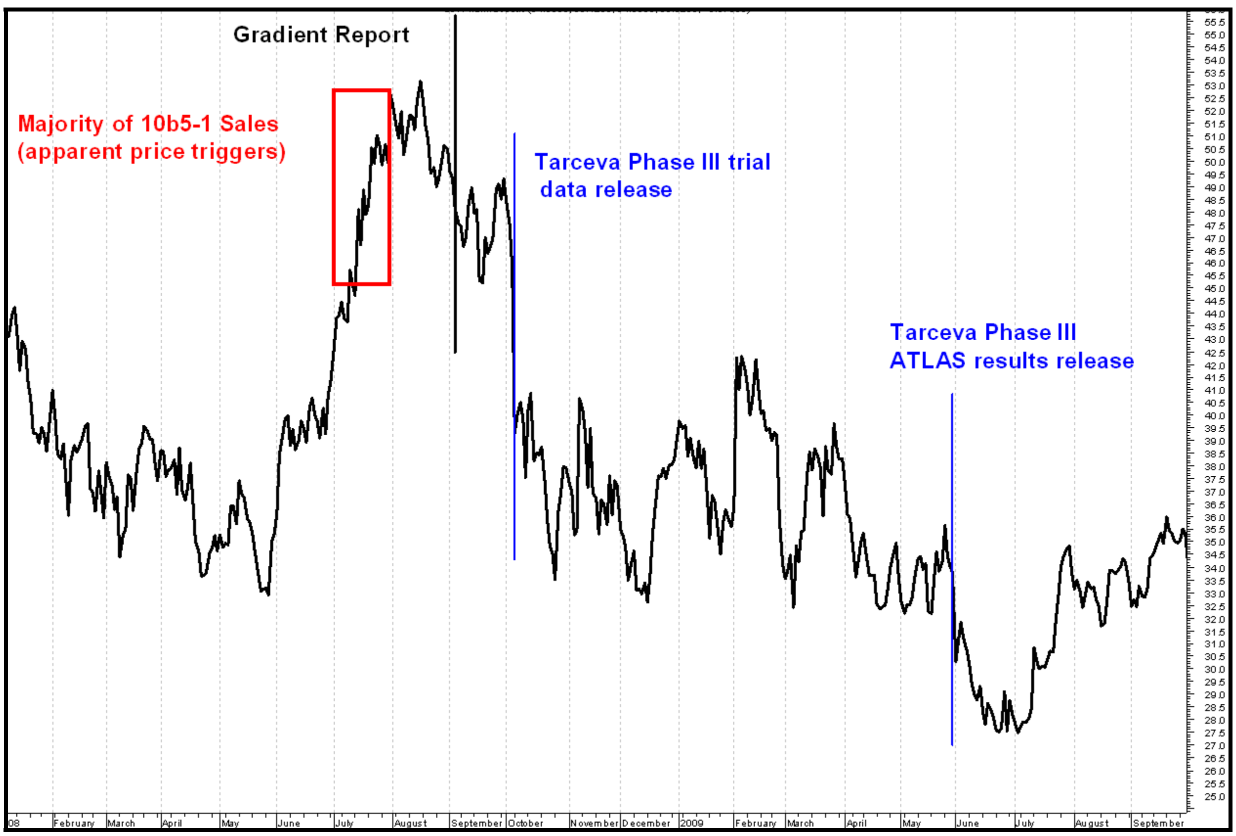
under 10b5-1 plans initiated between 02/28/08 and 05/01/08 with sales occurring thereafter. Another indicator of the aggressive use Rule 10b5-1 was the large volume of shares sold in a short time. Of shares sold under the plans, 88% were sold between 07/01/08 and 08/01/08. Sales occurred at a three-year high in share price, with indications of share-price triggers from at least three Section 16 filers.

The firm's executives and directors—most notably the division president in charge of Tarceva—were also noted to have a history of well-timed sales.[5] With numerous clinical trial results for Tarceva and its competitors due out in H2 2008, we believed that "outsized sale activity may indicate a lack of confidence in future performance of OSIP by executives."

Chart 5. OSIP: Aggressive Sales Under Rule 10b5-1 and Subsequent Share-Price Performance.



[5] Thirteen previous sales by Gabriel Leung, division president of oncology (in charge of Tarceva), preceded an average six-month (12-month) share-price decline of 12.5% (41.3%).

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As shown in Chart 5 (above) OSIP began to significantly disappoint the market just two months after the period of historically outsized 10b5-1 sales, which had occurred in a short period of time. Specifically, on 10/06/08, the biotech firm released data showing that a Phase III trial of Genentech's (DNA) Avastin, when combined with Tarceva in certain patients with certain forms of advanced lung cancer, did not appear to increase survival compared with Tarceva plus a placebo. In mid 2009, the firm released data from the Phase III ATLAS study on the Tarceva/Avastin combination indicating a modest improvement in survival rates, but with consistent adverse effects seen in earlier studies.

We discontinued coverage on OSIP on 09/11/09 after a year since initiation. Over that period OSIP fell as much as 42% on an absolute basis.

RIVERBED TECHNOLOGY INC. (RVBD)

We initiated coverage of Riverbed Technology Inc. (RVBD) in mid June 2009 on an unusual increase in 10b5-1 plan sales. Shares of the Network & Communications firm were up over 200% since November 2008, and the increase in executive sales volume under 10b5-1 plans appeared to reflect possible share-price triggers. Our conviction about the behavioral signal was strengthened by the fact that the executive sales came after the company reported the lowest level of new-customer sales in two years. Our outlook was framed by the expectation of a "decline in new-customer sales to … have an adverse impact on service-and-support revenues later this year (2009)."

Specifically, (before our report) in Q2 2009 five executives sold a total of 568,917 shares at a weighted-average price of $18.70, yielding proceeds of $10.6 million. Included among the sellers were Chairman and CEO Jerry Kennelly (266,667 shares), CTO Steven McCanne (201,850 shares), and CFO Randy Gottfried (20,000 shares). Adding to our interest in these sales was the fact the historical level of 10b5-1 selling per quarter by executive had varied considerably and the variation appeared to be a function of share price. This observation led us to believe that the 10b5-1 selling plans contained price triggers that led to higher (lower) sales volumes at relatively higher (lower) share-price levels.

We opined that "RVBD is at risk for a significant share-price decline over the next six months. Of note, this risk may be heightened around the July 23 release of Q2 results and forward guidance."

(See chart, **RVBD: Aggressive Sales Under Rule 10b5-1 and Subsequent Share-Price Performance**, *next page*)

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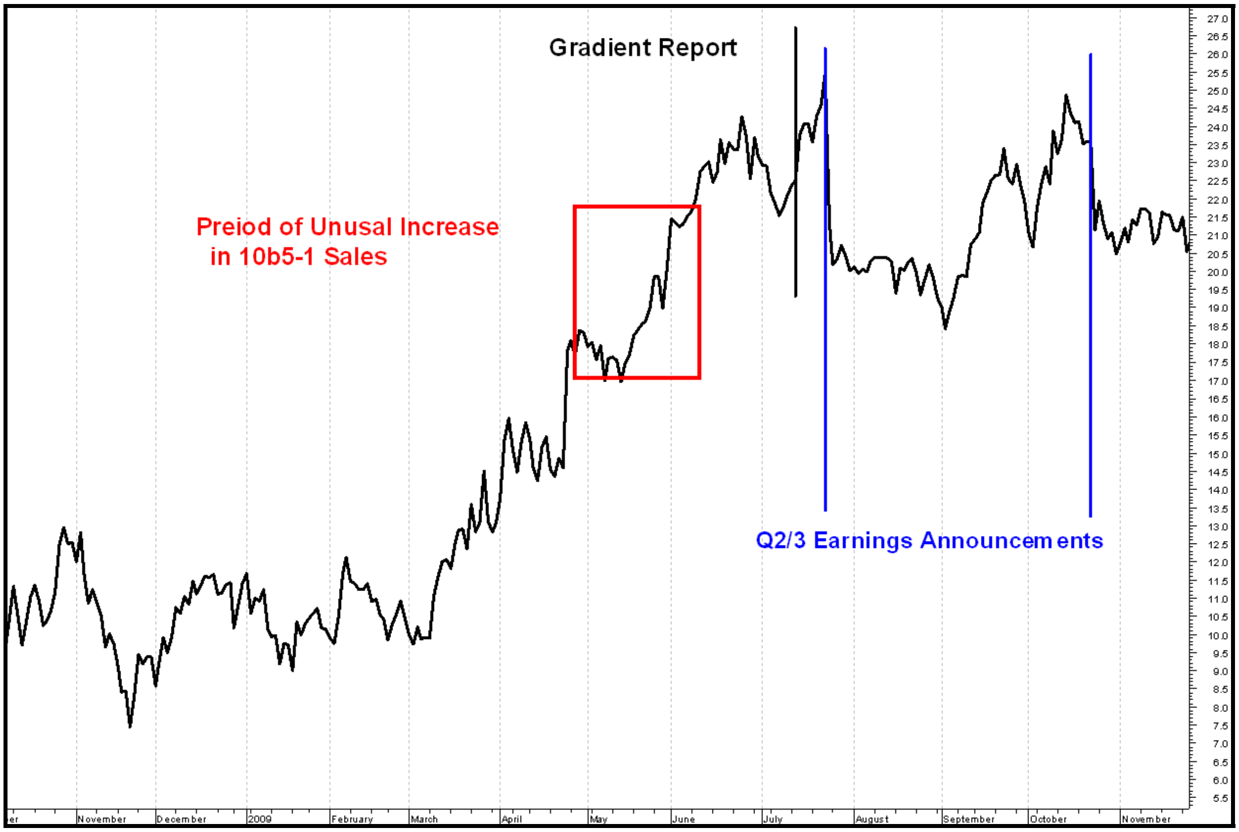
Chart 6. RVBD: Aggressive Sales Under Rule 10b5-1 and Subsequent Share-Price Performance



RVBD's Q2 earnings announcement on 07/23/09 was slightly below estimates, and forward guidance disappointed the market. Similarly Q3 results (10/22/09) suggested that the trends of the prior quarter remained in play. Though total product sales (i.e., product revenues attributable to new and existing customers) rebounded slightly in Q3, growth in service-and-support revenues continued to falter. Negative trends in sales to new customers likely contributed to the slowed growth in service-and-support revenues.

Nevertheless, with some evidence of a potential improvement in product sales (though the amount sold to new customers was unknown) and contemporaneous rumors of a potential buyout, we believed the risk of share-price underperformance had abated and discontinued coverage on 10/27/09.

Over the brief period of coverage, RVBD shares underperformed the Network & Communications and Devices industry as a whole by more than 30%.

NBTY INC. (NTY) — CURRENT IDEA

After successfully tracking NTY's upward trajectory in 2009 based on executives' outsized exercise-and-hold behavior, we reinitiated coverage with a grade of F on 02/24/10. Our negative outlook was driven by the record level of divestitures and the unusual nature of 10b5-1 plan sales that began occurring in late 2009 through early February 2010 as NTY's price appreciation pushed shares above what appeared to be price triggers imbedded in trading plans for several executives. Additional concerns included the material reduction in equity holdings and the track record of well-timed activity by executives who were active in the period. We also evaluated whether recent divestiture activity may be related to several signs of possible earnings-quality risk, including rising DSO and DSI, slowing organic growth, and potentially unsustainable operating margin performance.

Five Section 16 filers divested an aggregate 1.5 million shares of NTY for $66.2 million from 10/19/09 to 02/03/10. Of greater concern, trading-plan sales commenced at $42 ($45) for CFO Harvey Kamil (founder Arthur Rudolph) and resulted in the sell-through of 91.7% (100%) of scheduled plan sales in just three months (six days). The unusual 10b5-1 activity also reduced the combined beneficial ownership for Kamil and Rudolph by nearly 50% since October 2009. Most of this activity occurred in Q4 CY2010, when Section 16 filers sold 1.1 million shares (or 70.6% of total divestitures noted above) for $45.9 million. The volume of shares sold in calendar Q4 was the highest since Q1 CY2000, when four executives (including Kamil Harvey, Arthur Rudolph, and Scott Rudolph) sold 1.2 million shares ahead of average forward six-month returns of -59.2%. The dollar value of shares sold in calendar Q4 ranks as the highest in the firm's history.

(See chart, **NTY: Aggressive Sales Under Rule 10b5-1 and Subsequent Share-Price Performance**, *next page*)

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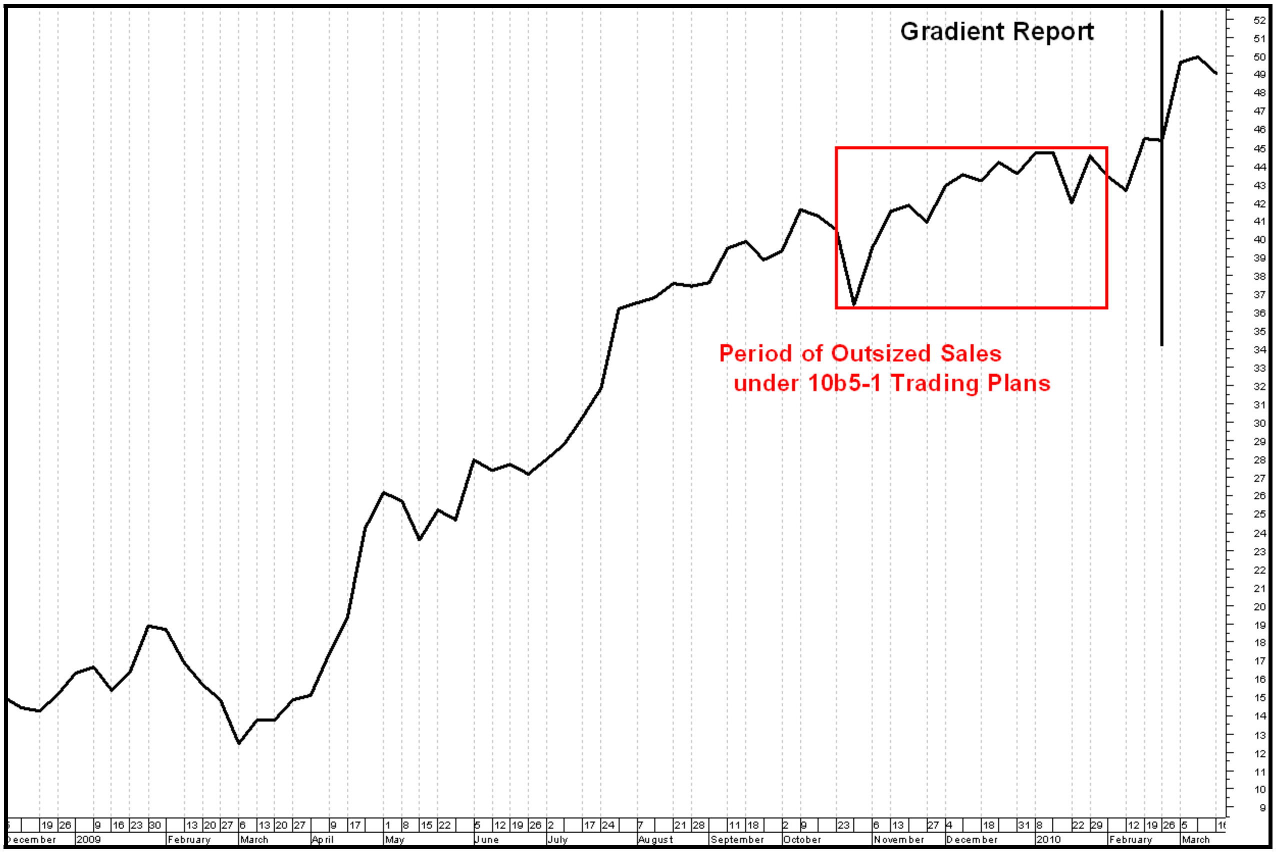
Chart 7. NTY: Aggressive Sales Under Rule 10b5-1 and Subsequent Share-Price Performance



Hedging: A Sure Bet on an Uncertain Return

HEDGING TRANSACTIONS

Theory supports aligning executives' personal wealth interest with that of shareholders, in part by granting significant equity rights to executives via stock options and restricted stock awards. However, executives can easily delink their personal fortunes from those of the firm by entering into hedging contracts. Consequently, executives who report significant ownership of company stock in their SEC filings may not actually have a material portion of their wealth tied to the success of the firm.

The use of hedging transactions by executives has important implications for both stock selection and portfolio risk management. In an academic study covering 2,010 hedging transactions across 911 unique firms over 11 years, Gradient co-founder/Chairman Dr. Carr Bettis and his co-authors Dr. John Bizjak and Dr. Swaminathan Kalpathy (BBK, 2009) provide compelling empirical evidence suggesting that, on average, executives appear to use hedging instruments "opportunistically" by entering into these transactions ahead of poor share-price performance and "bad-news" corporate events.

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While, on average, all hedging contracts are essentially "bad news" for investors, BBK (2009) also note important differences among different types of hedging instruments. To examine these effects, the authors subdivide their sample into four different types of hedging instruments. This portion of the analysis found that when executives used a collar instrument, company shares declined 22%, on average, relative to peers (based on industry and size) in the 12 months following the date of the hedging contract. The abnormal return results are qualitatively similar for prepaid variable forward-sale (PVF) hedging contracts. However, equity-swap transactions were followed by average excess returns of positive 11% over 12 months.

BBK (2009) also find that the precipitous share-price declines that tend to follow the use of some hedging instruments appear to be linked to future events (or at least the awareness of an increased risk of such events) that were known or reasonably could have been anticipated by the hedging executives. For example, executives using collar transactions are more than four times as likely (compared to control firms) to be embroiled in securities-related shareholder litigation and almost twice as likely to restate earnings the year after the collar transaction. Another important finding is that executives at acquiring firms were much more likely to use collar instruments, and acquisition activity tended to continue after the hedging transactions. These results suggest that collar (and other hedging) instruments may be useful in identifying cases in which executive sentiment regarding acquisitions may differ from the company's public disclosures. The evidence relating to corporate events surrounding hedging transactions was qualitatively similar for PVFs.

BOSTON SCIENTIFIC CORP. (BSX)

Our 01/22/09 *Alert* suggested a high risk of share-price underperformance at Boston Scientific Corp. (BSX) following the material amount of wealth hedged using forward-sale contracts. Specifically, BSX co-founders Peter Nicholas and John Abele received an estimated $60.8 million in proceeds on 6.7 million shares pledged in connection with prepaid variable forward-sale contracts initiated between 09/09/08 and 01/15/09. Including "involuntary" margin-call and other market sales in Q4 2008 and Q1 2009, the two co-founders hedged and/or sold shares with a market value of $538.5 million.

(See chart, **BSX Forward Sales and Subsequent Share-Price Performance**, *next page*)

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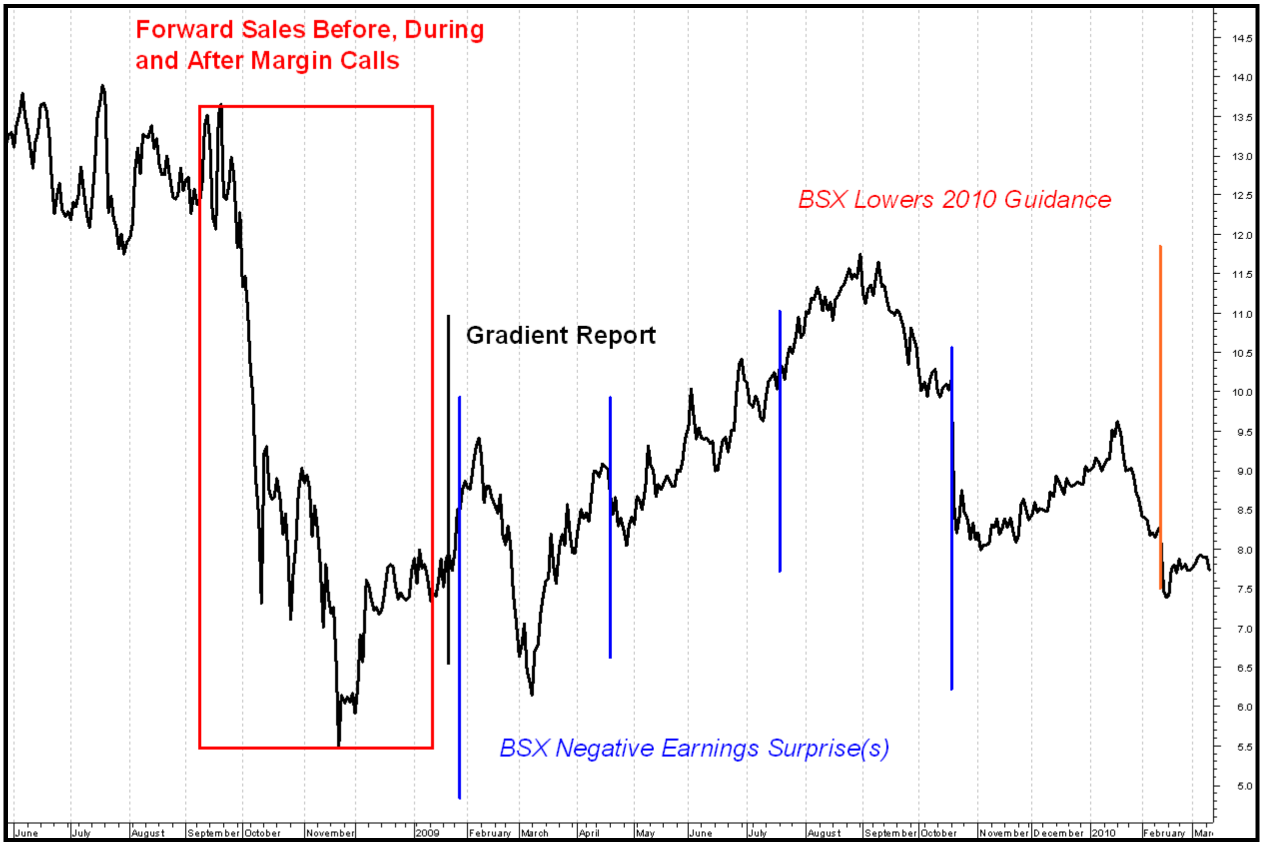
Chart 8. BSX Forward Sales and Subsequent Share-Price Performance



Our initial *Alert* warned that gross margins could remain under pressure if the company found it necessary to reduce prices in an effort to stave off potential market-share losses to Abbott Laboratories (ABT) and Medtronic (MDT). Though Q1 2009 results showed signs of improvement, the company subsequently saw gross margin fall for two consecutive quarters, including a 69 bps sequential decline in Q3. Consistent with our expectations, management attributed the sequential decline in Q3 gross margin to pricing pressures in several key markets, product mix, and product recalls (Q3 2009 analyst call).

Our initiation also expressed concerns about the quality of BSX's balance sheet, given the high level of soft assets, large debt load, and low cash balance. These balance-sheet items appeared to have weighed on the firm over the following periods. Though the debt load lightened slightly, soft assets (goodwill and intangibles) continued to constitute a large portion of total assets remaining well in excess of stockholders' equity. In addition to negative tangible equity, since the end of 2008 the company's cash position continued to fall.

We discontinued coverage on 02/12/10. BSX shares had declined 22.3% over our period of coverage on an absolute basis.

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Cerner Corp. (CERN) — current idea

Forward-sale agreements by executives at CERN in Q4 2009 followed the highest level of quarterly divestiture at the firm in three years. This executive behavior may indicate a more risk-averse view among high-level executives at CERN.

Ten executives/directors combined to sell 163,925 shares for $10.7 million in Q3 CY2009, which is the highest level of quarterly sales since Q4 CY2005. Dwarfing this outsized firm-level activity, in early November 2009 co-founders Neal Patterson and Cliff Illig adopted prepaid variable forward-sale contracts that effectively limit their downside risk on 500,000 company shares each. Each received $31.9 million in upfront cash consideration pursuant to an agreement under which the executives pledge to deliver the counterparty (which was not identified) up to 500,000 shares (or settle the contract in cash) upon expiration at 11/06/12.

These contracts may cause the counterparty to hedge its downside risk related to holding CERN shares during the contract period, via short sales, put options or other means.

According to Form 4 filings associated with the forward-sale agreements, both executives entered into the hedging contracts "primarily to provide funding for other business investments." To the extent that this explanation describes their motives, it also implies that the two executives viewed the potential returns on other investments as more attractive than retaining the full amount of any upside in CERN shares (at least as of the date the contracts were executed).

(See chart, **CERN Forward Sales and Subsequent Share-Price Performance**, *next page*)

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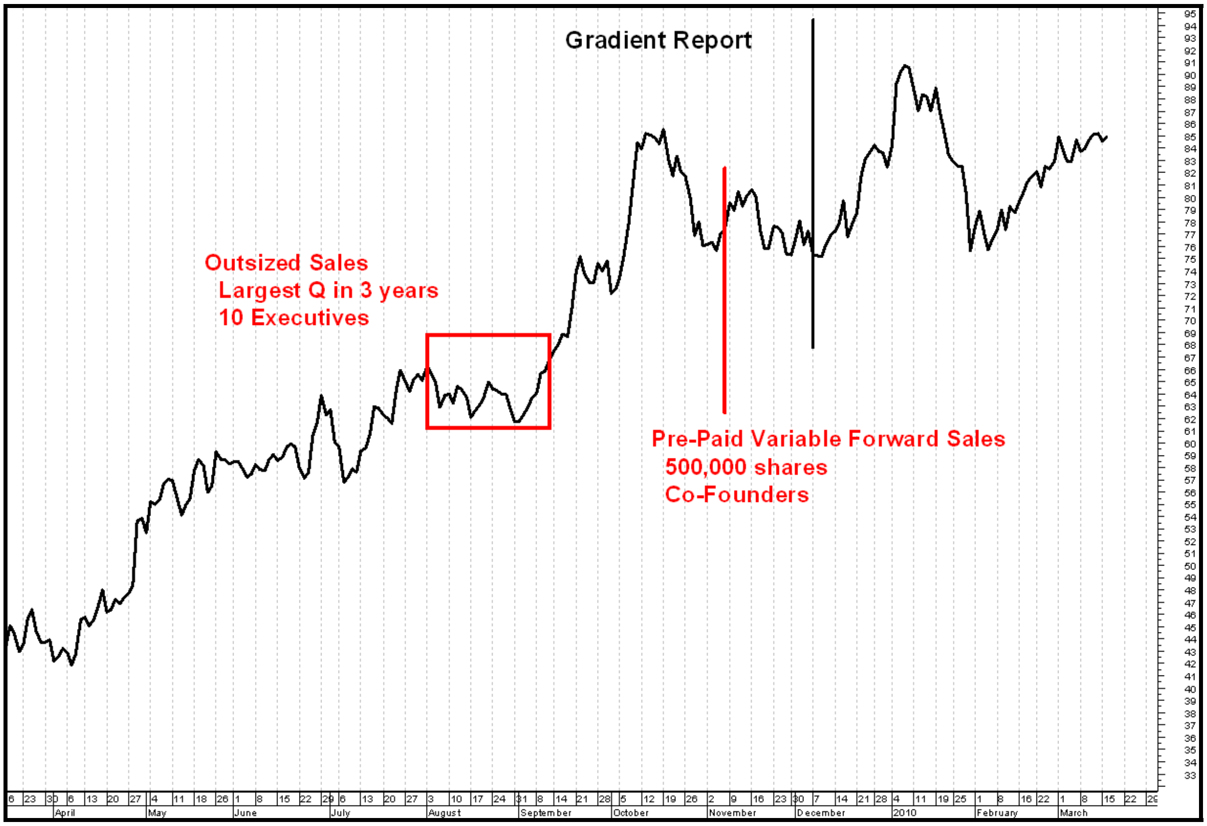
Chart 9. CERN Forward Sales and Subsequent Share-Price Performance



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