

**INVESTMENT LETTER**  
**ROSETTA STONE, INC. (NYSE: RST)**

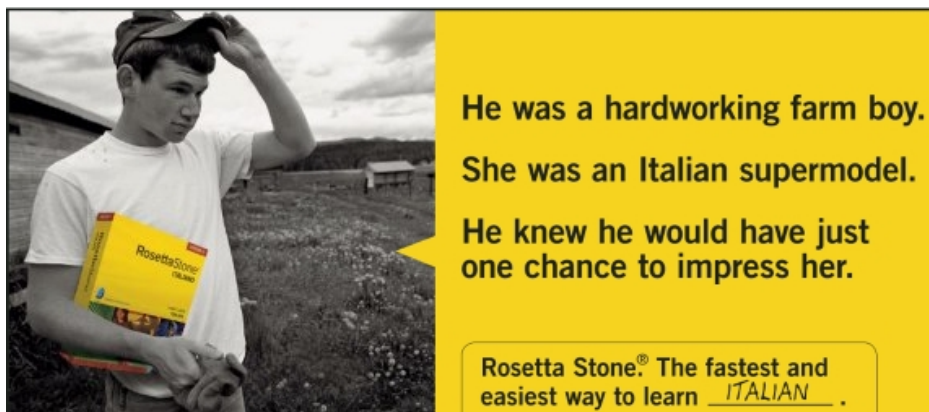
August 24, 2009

It was one of those bright, brutally hot mornings in late July in Tulsa when the sun is bearing down on you and all you can think of is getting into a building with air-conditioning. In Tulsa if a business wishes to keep its doors open (a confusing metaphor I admit when discussing the imperative nature of air-conditioning in Oklahoma) it must often turn its air conditioning on as early as March, and sometimes, even turn the a/c on as early as February.

I was driving toward my favorite Mexican restaurant in Tulsa, [El Rio Verde](#) at 38 North Trenton Avenue. I parked, walked a few steps toward the restaurant, opened the door, and greeted the owner and the staff, all of whom I know. “¿Cómo estás?” I began and we exchanged hellos. I wanted to continue the conversation and to talk about the heat, but my Spanish is primitive, and that evaluation may be kind. So, a few minutes later, consuming a pork, lettuce and tomato burrito, I reminded myself to do something about my Spanish speaking ability. With the press of business, however, I forgot about my self-promise and my Spanish remained primitive or euphemistically, basic.

Then, about three weeks later, on a Saturday morning in August, I was at [Borders](#), at 2740 East 21<sup>st</sup> Street, wandering around the store, entranced with the possibilities of learning provided by the wondrous selection of books, yet confused by the wide range of offerings. So I decided to take a break to seek some rest from the powerful, entrancing stimuli produced by the alluring graphics. It was as if I could not handle all the excitement and that I needed a quiet place to regain my composure. So I headed to the café in the store. After I had purchased an overpriced but delicious cup of chai latte I found the magazine rack, picked up a copy of [The Economist](#), walked to the cash register to pay for the magazine and then settled into one of the comfortable couches in the café.

I was in one of my pseudo-intellectual moods and as I read [The Economist](#), I glanced around every few minutes to be sure that everyone in the café knew that I comprehended everything I was reading. I was making soft yes sounds every few minutes as I turned the pages. I was turning the pages fast, not paying much attention to either the articles or the advertisements until I came to the advertisement shown below.



Perhaps the young farmer, I imagined, had developed an interest in the Italian supermodel after he had read a press release from her agents indicating that she would be making a brief stop in the city nearest to his town. The young farmer had followed the career of the Italian supermodel, always wanting to meet her. Now that he knew she would be visiting a nearby city, he wondered how he could meet her, and how he could impress her. He was excited but as a disciplined young man, he knew that in real life, first impressions are what count and he did not want, with an incomplete or incorrect knowledge of Italian, to disappoint the beautiful Italian supermodel. He had only a few weeks to bring his Italian up to snuff, and he had heard that the Dynamic Immersion courses in foreign language learning offered by **Rosetta Stone**<sup>1</sup> would do the job.

As I took another sip of the delicious beverage, I recalled that I had heard a lot about **Rosetta Stone**, remembering that the company had gone public in April of 2009 with the offering prospectus boasting that the company's mission was to change the method that people used to learn languages. The company proclaimed that its approach to learning languages was revolutionary, and disruptive.

What was this method, I asked myself? I made a note to go online on Monday and find the company's initial public offering prospectus. This is what I found:

Our teaching method, which we call Dynamic Immersion, is designed to leverage the innate, natural language learning ability that children use to learn their native language. Our courses are based on our proprietary technologies and pedagogical content, and utilize a sophisticated sequencing of images, text and sounds to teach a new language without translation or grammar explanation. (*Rosetta Stone, Inc. initial public offering prospectus, April 15, 2009, page one*)

Sometimes you need an extra dose of caffeine to get through an initial public offering prospectus and **Rosetta Stone's** was no exception. To get through the legalese and the pretentious language can be quite a challenge, just as getting through one of my letters can be quite an undertaking.

The company's income statement showed that it spent a good portion of its revenue every year on research and development and I assumed that a good deal of this money went to the creation and refinement of 'proprietary technologies'. So it was important for me to know what 'proprietary technologies' meant.

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<sup>1</sup> **Rosetta Stone** is proprietary language-learning software produced by Rosetta Stone, Ltd. Its title and its logo are an allusion to the Rosetta Stone, an artifact inscribed in multiple languages that helped Jean-François Champollion to decipher Egyptian hieroglyphics by comparing the inscriptions of the Coptic language, a version of spoken ancient Egyptian, and Greek, alongside the hieroglyphs.

The Rosetta Stone software utilizes a combination of images, text, and sound, with difficulty levels increasing as the student progresses, in order to teach various vocabulary terms and grammatical functions intuitively, without drills or translation. They call this the "Dynamic Immersion method". The goal is to teach languages the way first languages are learned. (*Wikipedia, 2009*)

What the company means by proprietary technologies, we discovered after a lengthy but productive phone call with [Chris Martin](#), the head of the company's investor relations, is the competitive advantage produced by owning more than four hundred thousand sound files and twenty five thousand plus pictures (mostly stock but some taken by in-house photographers) with these pictures and sounds sequenced with text to produce the most efficient experience.

Pictures, sounds, and text integrated to produce the fastest learning were proprietary and valuable, I could see, but I still had my doubts, I said to [Martin](#), that the 'pedagogical content' conveyed anything special. I wondered what his answer would be. He conceded that 'pedagogical content' was inserted at the insistence of one of the company's marketing specialists, and he was not sure how the word 'pedagogical' differed from the word teaching. I was pretty sure that there was no difference between pedagogical and teaching, but I had more important issues to pursue with him, and so I decided to confirm my hunch on my own time. Later, after we had hung up the phone and thanked [Martin](#) for his time, I looked up 'pedagogical': According to *Merriam-Webster's Collegiate Dictionary, Eleventh Edition, 2008* pedagogical was first used in 1619 and means "... of, relating to, or befitting a teacher or education."

Of course any textbook or other published learning material, any book or collection of thoughts assembled or otherwise designed to teach something, must have pedagogical content. So there is nothing new here.

But in the company's defense the pedagogical or teaching method that [Rosetta Stone](#) has created, and continues to improve with hefty annual expenditures on research and development, is revolutionary, or as the company says in its press releases, disruptive.

Why is the [Rosetta Stone](#) experience revolutionary? The [Rosetta Stone](#) experience is free of translation, [Martin](#) said, and does not depend on a human as teacher nor does it depend on the existence of a classroom. To learn a language with the [Rosetta Stone](#) method, all you need is a desktop or a laptop and the company's software. [Rosetta Stone](#) offers software packages that start at about two hundred dollars for one level, four hundred dollars for a three level package, and one thousand dollars for the newest addition to the [Rosetta Stone](#) family, the [TOTALE](#) package, a comprehensive online language learning solution that allows the student to speak, read, listen and write with [Rosetta Course™](#), participate in guided sessions with a native-speaking coach in [Rosetta Studio™](#), and practice his or her skills in an online community called [Rosetta World™](#), where the only language that is spoken is the language that the student is learning.

I asked [Martin](#) how the software worked. The software, he answered, presents a picture with the text linked to a person or to an activity. For example, the software used to teach Spanish shows a picture of a car. The Spanish word for 'car' appears but the English word does not appear. So there is none of the laborious translation that is crucial to the conventional, non interactive method of teaching a foreign or a new language. Instead, the learner links a word and its meaning instantaneously and does not have to understand grammar, nor does she have to understand the foreign word except through visual and voice recognition. The new Spanish word becomes part of the subconscious almost effortlessly, so that the person using the [Rosetta Stone](#) software is learning the new language as if he or she were a child listening energetically, rapidly absorbing a wide range of words, with their sounds linked to objects and activity, such as a table, or running.

A child, we know from millions of examples, learns a language without any formal, classroom experience, by absorbing the language into his or her subconscious as he or she listens to and watches his or her parents and other important people in their lives speak to each other and otherwise interact. Such learning is what the company means when it says that its software "...leverages the natural, innate ability of a child to learn a language."  
*(Rosetta Stone, Inc. initial public offering prospectus, April 15, 2009, page one.)*

In a traditional classroom setting the experience is not one on one and does not focus on each individual student but instead one is forced to learn as a group and to learn at the same pace as the group. This method assumes that everyone will learn at the same pace. But with the immediate response that the student enjoys with the **Rosetta Stone** software the student always has a chance to practice and perfect instantaneously what he or she has learned. He or she goes at his or her pace and can pause and reflect on a certain word when curiosity demands more time. In a traditional classroom setting there is not time for every student to practice what he or she has learned with the teacher. An alternative would be a language tutor for a one on one experience but one must also take into consideration that the chemistry between student and teacher must be good, and the learner or the student must often deal with inconvenient places and times.

The living room or the dining room or any room where the child hears and sees his or her parents and their friends talk becomes the child's classroom, except that this type of classroom is not what we as adults think of as a classroom: a place where we are required to be, a place of authoritarian dominance and character, a place with fatiguing rules where creativity and spontaneity are often discouraged, if not suppressed. (Of course the environment for language learning may not be healthy. If the child hears his or her parents say, for example, "...where is the book at?" the child may face some remedial grammatical problems later in life.)

After talking with **Martin**, I returned, the next day, to the prospectus. After all of my petty criticism of the company's pretentious use of the phrase 'pedagogical content' I realized that the company indeed did have a revolutionary product, and that this product must be successful.

**Rosetta Stone**, I could appreciate, had created a different kind, and a powerfully effective, kind of classroom. Instead of having to walk or drive to a building, and sit in an austere setting with your concentration interrupted by the ringing of a cell phone, the coughing of other students, or the droning of the professor, you could turn on your laptop, wherever you were, and immediately immerse yourself in the study of a foreign language, with your work reinforced immediately with a green check when you delivered the correct answer. The Rosetta approach, I could see, could be fun and inexpensive in terms of money, energy, and time. Above all, this approach was effective.

As I studied the prospectus I could not help but remember my early experiences with learning French, and the laborious work I did, work that seemed to be in marked contrast with the energizing **Rosetta Stone** approach.

My mother and father were continuously, zealously, and selflessly trying to improve all of my skills, without realizing the challenge they had taken on. My parents, I thought, were trying to send me to metaphorical finishing school, to help me complete my education with finesse. That is what I thought when I was thinking optimistically. But when, after hours of solo practice with the French language, trudging through nouns and verbs, often

giving the wrong gender to a noun, I sometimes thought that my parents were trying, I feared, however inadvertently, to finish me off.

My parents were on a vigilant, intensive quest to help me improve my skills, that is all of my skills but especially those that they thought would take me far in life. These were the skills that would make me a complete student, if not a complete young man. Learning the French language was a high priority skill. This quest seemed to gain acceleration as I entered the eighth grade in junior high school in New York City.

My mother was friends with a woman who had moved to the United States from France and who, evidently, needed some spare cash. The answer to her financial pinch was to tutor people in the French language. The French expatriate lived in an apartment building close to our apartment building. Once a week, after dinner, I walked to the French teacher's apartment where she patiently tried to teach me the basics of the language. She reviewed all the rules of grammar, sentence construction, and other topics that were tedious and exhausting. I admired her patience but I just could not get excited about her teaching methods. I was not inspired. It was if she were lecturing me. This was not what [Rosetta Stone](#) calls Dynamic Immersion. This was thorough submersion, or dynamic submission. Take your pick. Let us just say that taking the French lessons was not the highlight of the week.

What did customers think of the [Rosetta Stone](#) offering, I asked [Martin](#)? In its latest survey of the company's institutional customers in the United States, completed in February 2009, eighty seven percent of the respondents expressed satisfaction with the company's products, with a satisfaction rating of 6 or higher on a 10-point scale, and seventy per cent had recommended the company's solutions to other organizations."

The company's latest survey of its individual customers in the United States, completed in February 2009, revealed that 92% of respondents expressed satisfaction with the company's solutions.

I was eager to test [Rosetta Stone's](#) bold claims. It was not to difficult to get a trial run of the first level of the English to Spanish course, a trial that [Chris Martin](#) promised to arrange for us.

Soon our email boxes showed that we had received the trial subscription and that we could proceed with our Spanish lessons.

## ROSETTA STONE, INC. INVESTMENT THESIS

The worldwide language industry in 2007 was an eighty three billion dollar market, of which thirty two billion dollars was for self-study.

There are many forces that encourage people to learn a foreign language: individuals seeking the enjoyment and enrichment brought by learning a language, professionals conducting business in a global economy; schools educating students in foreign languages; companies using foreign languages as part of a training program; armed forces training for soldiers; immigrants and expatriates seeking to master their new environments; and parents enhancing their children's education.

In the United States, where **Rosetta Stone** produced ninety five per cent of its revenue in 2008, the market is fragmented, with the following methods in use: classroom instruction using the traditional or oldest approach of memorization, grammar; and translation; immersion-based classroom instruction; self-study books, audio tapes and software that emphasize the rules of grammar and **Rosetta Stone's** Dynamic Immersion.

**Rosetta Stone** has several competitive advantages. First, its Dynamic Immersion system is more convenient and more affordable than classroom techniques, and more effective and engaging or fun than self-study methods. Second, is what the company calls its 'technological platform'. (The word 'platform' as Diane Law says in her *Lexicon Of Corporate- And Office-Speak* published by Constable & Robinson, Ltd., 2008, is often used incorrectly or pretentiously. Writers consider 'platform' to be, especially in software discussion, code or other intangibles that produce 'economies of scale' instead of something tangible that you stand on.) Because the pictures the company uses can almost always be used to teach every language and because only a small percentage of pictures require modest localization, there are great economies of scale in extending its products to more than one language. For example, nearly ninety per cent of the photographic images that can be used to teach Spanish can also be used to teach German, or French, so that the company can enjoy efficient use of research and development expenditures and can enjoy a high return on investment. Third, **Rosetta Stone** is by far the most recognized brand and enjoys the greatest market share in the language learning business in the United States.

We expect the demand for **Rosetta Stone's** products to outpace the steady growth in language learning and we see a big opportunity for the company abroad, although foreign success will require the building of a brand name, something that the company has done well, but with much effort and money, in the United States.

The language learning industry is big and growing and **Rosetta Stone** is the fastest growing company in the industry, giving the company excellent growth prospects.

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Note: The company's balance sheet is just a stone's throw away from perfection. As you can see for example on the next page, as of June 30, 2009, there is no long-term debt. Note as well the jump in cash and cash equivalents from December 31, 2008 to June 30, 2009, a result of the April 9, 2009 share offering.

**ROSETTA STONE INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except per share amounts)

	<b>June 30, 2009</b>	<b>December 31, 2008</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$66,173.00	\$30,626.00
Restricted cash	\$62.00	\$34.00
Accounts receivable (net of allowance for doubtful accounts of \$1,137 and \$1,103, respectively)	\$25,172.00	\$26,497.00
Inventory, net	\$6,581.00	\$4,912.00
Prepaid expenses and other current assets	\$7,117.00	\$6,598.00
Income tax receivable	\$7,133.00	-
Deferred income taxes	\$2,282.00	\$2,282.00
<b>Total current assets</b>	<b>\$114,520.00</b>	<b>\$70,949.00</b>
Property and equipment, net	\$17,962.00	\$15,727.00
Goodwill	\$34,199.00	\$34,199.00
Intangible assets, net	\$10,611.00	\$10,645.00
Deferred income taxes	\$6,828.00	\$6,828.00
Other assets	\$753.00	\$470.00
<b>Total assets</b>	<b>\$184,873.00</b>	<b>\$138,818.00</b>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$3,229.00	\$3,207.00
Accrued compensation	\$6,352.00	\$8,570.00
Other current liabilities	\$19,888.00	\$21,353.00
Deferred revenue	\$16,379.00	\$14,382.00
Current maturities of long-term debt - related party	-	\$4,250.00
<b>Total current liabilities</b>	<b>\$45,848.00</b>	<b>\$51,762.00</b>
Long-term debt - related parties	-	\$5,660.00
Deferred revenue	\$1,841.00	\$1,362.00
Other long-term liabilities	\$818.00	\$963.00
<b>Total liabilities</b>	<b>\$48,507.00</b>	<b>\$59,747.00</b>
Commitments and contingencies		
<b>Stockholders' equity:</b>		
Class A, Series A-1 Convertible Preferred Stock	-	\$26,876.00
Class A, Series A-2 Convertible Preferred Stock	-	\$17,820.00
Class B Convertible Preferred Stock	-	\$11,341.00
Non-designated common stock	\$2.00	\$1.00
Additional paid-in capital	\$128,264.00	\$10,814.00
Accumulated income	\$8,326.00	\$12,422.00
Accumulated other comprehensive loss	(\$226.00)	(\$203.00)
<b>Total stockholders' equity</b>	<b>\$136,366.00</b>	<b>\$79,071.00</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$184,873.00</b>	<b>\$138,818.00</b>

A few days later I logged on to the first lesson in Spanish. Immediately, two smiling faces, one boy and one girl, appeared on the screen, with the words, **niño** and **niña**, respectively, above the faces. I was also reminded of the company's powerful speech recognition program and its adaptive recall algorithms that repeat the pictures, the sounds, and the text (only in the foreign language) at strategically placed intervals, that is, intelligently arranged sequences.

The company had noted in its initial public offering prospectus that its approach required no translation. I searched and I searched and I could not find the word 'child' on the page where the words **niño** and **niña** appeared. Nor could I find the word 'child' on any page. Instead of a laborious translation that demanded rote memorization, I was able to learn what **niño** and **niña** meant by looking at pictures that identified a boy and a girl, and listening to words that identified the boy and the girl, with no English appearing.

After I had learned what **niño** and **niña** meant, after I had mastered the most basic of the basics, it was time to learn grammar. Again learning was done without translation but with pictures and sounds. I observed two girls, and two boys, with the words **los niños**, and **las niñas**, respectively. I was excited, now that I had entered the world of modern language learning, with the sequencing of the content designed to optimize learning.

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As of August 21, 2009, clients, officers, shareholders, and employees of the **Fredric E. Russell Investment Management Co.** have a position in **Rosetta Stone, Inc.** a position of **103,213** shares (**Fredric E. Russell** holds **17,413** shares). We may liquidate, decrease, or increase these positions at any time, without notice before or after we do so.

The writer of this report, **Fredric E. Russell**, lists his academic and professional background as follows: **B.A., Swarthmore College**, Swarthmore, PA; **M.B.A, and M.A., Washington University**, St. Louis, MO. He also holds the **CPA certificate**, and has taught accounting at the university level. He believes his love for writing and his usually correct grammar come from spending four years learning the English language at **Deerfield Academy** in Deerfield, MA, and from reading everything well written he can find. This method of learning how to write, he says, is called Dynamic Literary Immersion. The inspiration for which is **Rosetta Stone's** Dynamic Immersion.

You may read more about us, find other investment letters and the details of our record on our website: **www.fredricerussell.com**.

**Bibliography** (The brain is a popular subject today and the following books contain passages on language learning and the brain. Admittedly the reader may find more extensive lists of books on language and the brain. )

1. *The Britannica Guide to The Brain*, Introduction by Cordelia Fine, Encyclopaedia Britannica, Inc. published by Constable & Robinson, Ltd., 2008
2. *Inside The Brain*, by Ronald Kotulak and *The Chicago Tribune*, published by Andrew McNeel Publishing, 1996