

FEAR AND APATHY REIGN

Two months ago I worried about a sideways to down market for the summer months and maybe longer, and that is certainly what we've had so far. While second quarter earnings reports were pretty darn good, the good news was not met with enthusiastic buying. Investors seem apathetic to good corporate fundamentals. In fact, stockholders are selling on *good* news, unless it's a *huge* upside surprise. And when bad news—real or rumor—surfaces, investors cannot sell fast enough. The very real fear of terrorism has permeated market sentiment.

The month of July was a disaster: the Dow was down 2.8%; Nasdaq down 7.8%; and the S&P was down 3.4%.

With the question marks of the presidential election still three months away, and terrorist threats never going away, I have removed all marginal buy recommendations from my Growth Stock Recommendation List, keeping only the few I think are really good buys now. (Those removed and the reasons for removing them are discussed at the end of the Buy List.)

In addition I have been recommending stocks that are more defensive, dividend-paying, and more value- than growth-oriented. These companies will not appear on my Growth List, but may be appropriate, if you are feeling defensive or fearful about the market. Ask me about these investments.

GROWTH STOCK RECOMMENDATION LIST

As always, the companies on my growth recommendation list are quality stocks with sound fundamentals, and they meet my criteria for growth at a reasonable price (GARP). Their growth outlook is more robust than that of the S&P 500; they are lead by topnotch management; debt is reasonable; and they are not overpriced, as measured by ratios of price to earnings, sales, and future earnings growth.

The following comments update information about and my views of the stocks on my list:

TECHNOLOGY

UTStarcom (UTSI \$18, P/E/G 0.57) – The company reported second quarter earnings that were 2 cents less than the expected \$0.34; profit margins were guided down to 27%-28% vs. the expected 30-32%; and the company guided 3Q EPS and revenues lower than current estimates. While these things are not good news, they are not as bad as the almost 30% sell-off suggests. The earnings would have beaten by a penny except for one international order being delayed by one day, pushing it into the 3Q. To remedy the supply constraints that caused the delay, the company has hired a supply chain consultant to streamline and process orders. The profit margins got squeezed because there is more

competition for handsets in China, and this was the main reason for the fire sale. But UTSI has been diversifying their business model to transform themselves into a global telecom solutions provider. This transition will take time. Global demand for their products is very strong, and the stock is undervalued now, which is the good news (and reason to own this stock).

The company is projected to grow 19% annually over the next five years, which isn't enough for those looking for a repeat of 2003's doubling of revenue. Even if the 19% turns out to be overstated by my 5% test (see GARP strategy on www.fizone.com), 15% growth still beats the S&P, and with the P/E at 11 times next year's earnings, the price is very reasonable. The market's current negative sentiment toward the stock is the biggest risk to buying shares now.

HEALTH CARE

Amgen (AMGN \$56, P/E/G 1.18) – I believe the current price offers a good opportunity to own this stock at a reasonable price with little downside risk. With a P/E/G under 1 (using 2005's EPS estimate) and Amgen's improving pipeline, S&P calculates a 12-month target price of \$80. Amgen, the largest biotech firm, conducts research in and develops human therapeutics based on cellular and molecular biology. Major products include: Epogen (red blood cell stimulation in bone marrow), Neupogen and Neulasta (white blood cell stimulation), Enbrel (psoriasis), and Aranesp (anemia). Second quarter sales were better than forecasts, and EPS for the quarter beat by a penny. S&P forecasts total sales for 2004 of \$9.7 billion and \$11 billion for 2005. Another promising new product, AMG 167, for the treatment of osteoporosis, is scheduled for Phase III trials later this year.

Teva Pharmaceutical (TEVA \$29, P/E/G 1.03) – Current price reflects a 2-for-1 stock split at the end of June. Teva is the largest supplier of generic drugs, makes bulk pharmaceutical chemicals, and has a successful proprietary drug, Copaxone, which is an injectable treatment for multiple sclerosis. They recently acquired Sicor, maker of finished dosage injectable products. Teva is one of the most profitable firms in the generic sector, partially due to how successful management is at "infringing" on impending patent expirations. Teva often produces the first generic version of a branded drug, negotiating deals to share revenues from the generic until the branded patent expires, thereby assuring that Teva is the first generic to market. Or, if another company wins first-to-market 180-day exclusivity for a new generic drug, Teva will cut a deal to pay royalties to the other company, while they are allowed to create and sell their own generic. S&P expects revenues to advance to over \$4.6 billion in 2004, sees Copaxone sales increasing 20%, and assigns a 12-month target price of \$44.

FINANCIAL

Capital One (COF \$69, P/E/G .78) – While most of the market experienced huge losses in July, Capital One's stock gained almost \$1 per share. Imminent interest rate hikes have lowered this financial stock's price from its \$77 high in April.

However, higher short term rates really don't threaten Capital One's earnings. The company has been diversifying and changing their business model, switching their loan customer focus from the sub-prime segment to the super-prime segment, resulting in lower loss rates. Their international and auto-lending segments have been growing; and now CEO Richard Fairbank has announced that they will enter the banking business via an acquisition. Capital One's extensive database of information collected from its customer accounts distinguishes it from other financial services firms and gives it advantages in areas such as marketing and collection, which it does itself rather than outsourcing. Their database tells them which loans are likely to be profitable in pursuing recovery and which to charge off. Standard & Poor's raised its rating to Buy, as second quarter earnings were so good, and they have a 12-month target price of \$88.

INDUSTRIALS – Currently no stocks on list.

ENERGY

Nabors Industries (NBR \$46, P/E/G 1.16) – Nabors is the largest oil and gas land drilling contractor, operating primarily in the U.S., but also internationally, with some offshore rigs in the Gulf of Mexico. Nabors has most of the idle rigs in the Rockies, where the exploration and production companies are drilling more to keep up with increased demand for natural gas. This increased demand puts drillers in position to charge higher day-rates for their rigs. Consensus is that natural gas prices will stay high through 2004, and that drilling activity has not yet reached its peak. Standard & Poor's has a Buy rating and a 12-month target price of \$53.

Drilling is a high risk business, because of the frequent negative impacts of weather and geopolitical turbulence. (Nabors warned in early July that, because of weather and unavoidable downtime in several rig locations, second quarter earnings would be closer to \$.27-\$.28 rather than the expected \$.35, before ultimately reporting \$.30, which was then an upside "surprise".) However, the oilfield services sector is also the highest growth of the energy sectors, which is why Nabors makes the Growth List.

RETAIL/CONSUMER

Panera Bread Company (PNRA \$36, P/E/G .98) – Management has not stopped their expansion plans in spite of the low-carb diet craze. They recently announced they will add 27 new restaurants in three states. They have also equipped more than half of their 640 cafes with free high-speed broadband internet access, or Wi-Fi, making it the largest hotspot network in the U.S. These upscale, but casual bakery-cafes specialize in high-quality food for breakfast and lunch, founded on the concept that customers' preferences are changing from fast food to a more specialty dining experience. They feature fresh-baked goods, custom-made sandwiches (on fresh-baked bread), soups, salads, and fresh-roasted coffee and other beverages. The current low-carb fixation has hurt the

restaurant some, and so have the recent high prices of butter and milk. Annual revenue growth is anticipated to be about 23% over the next five years, and earnings are forecast at 30% annually. One potential negative to future earnings is the extensive use of unexpensed stock options the company grants. Another is if expectations turn out to be too high. I like this company, but it is priced for growth.

CHANGES TO PREVIOUS LIST (6/04)

These companies were **removed** from the Recommendation List:

Flextronics (FLEX \$12, P/E/G .90) – Flextronics just completed a secondary offering, adding 24 million more shares outstanding (at \$12.50) at a time when the stock price has been suffering a great deal. They raised \$300 million to reduce debt, but they have diluted the value of the already weakened stock. Management has continued to raise guidance, and earnings reports have been good, but the stock price continues to fall. Even though demand for its products continues to improve, demand is not robust, and margins are barely breakeven. While revenues have increased each of the last 10 years, earnings per share have been negative for the last four years. S&P, which rates the stock a Buy, has lowered its price target to \$20 from \$27. The business has just not been profitable.

Sell or Keep: I think I may **sell** my shares and avoid the electronic manufacturing contractors in the future.

L-3 Communications (LLL \$61, P/E/G 1.20) – There is nothing wrong with this company or its future outlook. They have reported good second quarter earnings, better than expected, and they continue to sign new contracts for their defense and security systems. The stock is near its 52-week high of \$66; and its forward P/E and P/E/G are at the upper limits for its 15% long-term growth estimate. Therefore, I would look for a lower entry point.

Sell or Keep: It's a **keeper**.

Comcast (CMCSK \$28, P/E/G 4.92) – Comcast is in a “death match” with the satellite companies and the Baby Bells to see who can offer all services—bundling telephony, video content, and broadband access—thus capturing customers from each other. This drastic competition has led to such extreme discounts, profits are slim. The cable companies have had the most capital expenditures to establish their infrastructure. S&P expects the company to generate more than \$2 billion in free cash flow in 2004, rates it a Buy, and maintains their \$39 price target.

Sell or Keep: Even if Comcast ends up being one of the last ones standing, I think it will be a long, difficult journey and is way too expensive now for the difficulties it faces. **Sell**.

Biogen IDEC (BIIB \$60, P/E/G 1.47) – The stock price has come down a few points in the last couple of months, and S&P has raised its target to \$72. The company recently reported its first positive earnings since the merger with IDEC,

and sales of its multiple sclerosis drug, Avonex, have been strong. Antegren, for treatment of both multiple sclerosis and Crohn's disease, is expected to receive marketing approval by the end of this year. Earnings for 2004 and 2005 are projected to be \$1.44 and \$1.74 respectively, which results in a Forward P/E of 42 and a P/E/G of 1.47.

Sell or Keep: Only because of the high valuations have I removed it from the list. If you are nervous about the market selling companies that are too expensive, you could take profits now. Otherwise, I would **keep** this biotech stock.

Cardinal Health (CAH \$43, P/E/G .78) – Everything has changed with respect to this pharmaceutical supply distributor. The SEC has intensified its investigation into accounting; the CFO and treasurer both resigned abruptly; quarterly earnings release has been postponed; and the stock price is \$27 lower than it was a month ago. S&P's 12-month price target has gone from \$75 to \$35, as they think it will be 2006 before Cardinal adjusts to the fee for service business model and reinvigorates gross margins.

Sell or Keep: Sell

Pfizer (PFE \$32, P/E/G 1.16) – Pfizer has lots of things going for it. They have the most blockbuster drugs. Their drugs treat many kinds of illness—cancer, depression, ED, high blood pressure—you name it. Ten of their drugs generate sales exceeding \$1 billion a year each. And yet their long-term growth is estimated at only 13%, the same as the S&P. The company just lowered its forecast for 2004 revenues by about \$1.5 billion. Standard & Poor's price target is \$43, which offers plenty of upside. But investors have been reluctant to buy the stock, probably because of potential political risks for the health care industry.

Sell or Keep: I'm lukewarm right now on this stock, but I will **keep** it.

Pioneer Natural Resources (PXD \$32, P/E/G 1.22) – Pioneer reported second quarter income below expectations—\$.58 vs. \$.65—even though revenue increased by 30%, and oil prices were higher. The problems were increased costs, some associated with the acquisition of Evergreen Resources, and increased tax expenses. The company reduced debt in the second quarter by \$65.3 million and repurchased 320,000 shares outstanding. Standard & Poor's lowered their rating to Hold and reduced their 12-month target price to \$36 from \$38.

Note to environmentalists: Pioneer is one of five companies that recently bid for and won leases from the BLM to explore lands in the northwestern corner of the National Petroleum Reserve-Alaska.

Sell or Keep: Pioneer's long-term growth outlook is only 11%, and 2005 earnings are projected to be lower than 2004. I'm thinking I should find a better oil company to **switch** to.

Sharper Image (SHRP \$26, P/E/G .63) – This retailer becomes a questionable holding when consumer spending decreases, which is what recent data indicate. And consumer discretionary stocks tend to suffer from rising interest rates, as consumers cut the extra stuff from their budgets. The fundamentals are still good:

zero debt, projected 21% annual growth, and P/E/G and price/sales ratios under 1.

Sell or Keep: The way I'm feeling about the weakness in the overall market, I feel even less confident about this seller of expensive gadgets. **Sell.**

No stocks were **Added** to the list.

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