

FOCUSING ON EARNINGS GROWTH

“The price of oil and its implications on the US and global economy are currently holding the equity markets captive. But, with strong global demand trends (20.4 mln bbl/day up 1.9% y/y) and below-normal inventory levels, we would not expect prices to drop below the \$40 level for the near-term. The DOE reported that it thinks prices are not likely to fall below this level until the end of 2005, which denotes a strong outlook for the sector.” Briefing.com, 10/25/04

The above quote explains perfectly why I have been recommending so many energy stocks. It also blames the volatile but rising price of oil for the stock market's inability to thrive as earnings get stronger. I think investors will come to terms with the price of oil, eventually accepting \$40 to \$50 per barrel. After all it peaked at \$80 in 1981, if you factor in inflation.

For the next seven or eight months I expect stock prices to increase, reflecting the strong earnings increases companies have been reporting throughout the second and third quarters. Earnings for the S&P 500 are expected to come in for 2004 above \$60, probably closer to \$63, an increase of 22% to 28% for the year. Meanwhile prices, using the benchmark S&P 500 Index, have increased only 8% (from 1034 one year ago to today's 1119).

The resulting price to earnings ratio (P/E) is about 18, down from 31 one year ago. This means stock prices are generally no longer over-valued. It also means investors are not willing to pay such high prices as they once were. So, we must be even more selective, focusing on stocks in each industry with the best earnings potential.

Since growth momentum alone cannot carry a portfolio anymore, growth stocks must also have solid earnings growth. In addition to the greater emphasis on strong earnings, I am recommending more stocks that distribute healthy chunks of their earnings to investors. Therefore, I will now have two lists: Growth Stocks and Stable Growth/Income Stocks.

GROWTH STOCK RECOMMENDATION LIST

Since I have removed the more speculative growth stocks from my list, the list is short and not much changed. 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 –

Rofin-Sinar Technologies (RSTI \$29, P/E/G .79) – Added to the list today

This German company is all about laser technology. They make large lasers that cut and weld vehicle components and body parts (macro); they make compact laser devices for the dental and jewelry industries (micro); and they develop custom-made laser labeling systems for smart cards, ceramics, keyboards, wafers, etc. (marking). They have been in business more than 25 years and have production locations in the US, the UK, Japan, and Singapore, as well as in Germany. It is not a business I pretend to know anything about, but the excellent investment fundamentals of the company came to light in various stock screens that fit my GARP criteria. It's clearly not over-priced at only 16 times 2005's projected earnings of \$1.94; divide that P/E by the 20% projected growth rate, and you get a P/E/G well under 1.00. The two screens that really got my attention were the EPS Growth and the Cash Flow Growth screens. According to Reuters Rofin-Sinar has grown revenue and earnings 17% and 17.54% over the last five years. Earnings growth in recent quarters has exceeded 50%. The Zack's cash flow screen identifies stocks that have current cash flow at least equal to their 5-year average, and the company must be ranked #1, i.e. Strong Buy, by Zacks.

HEALTH CARE

Amgen (AMGN \$56, P/E/G 1.21) – I believe the current price offers a good opportunity to own this stock at a reasonable price with little downside risk. For a projected 19% annual growth in EPS, the company is attractively priced. Holding the price down has been the uncertainty of 2005 changes in the Medicare Reform Act, as it is unclear what impact this legislation might have on reimbursements for Amgen's drugs. Third quarter revenues were better than expected for Epogen, Neupogen/Neulasta, and Enbrel, but revenue for Aranesp, while quite strong, was less than expected. Positive Phase II trial results were announced in October for its promising osteoporosis drug, currently called AMG 162.

Teva Pharmaceutical (TEVA \$26, P/E/G .94) – 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 expect revenues of \$4.5 billion this year, and they have been one of the most profitable firms in the generic sector. Recent data on Copaxone's effectiveness in treating MS patients and Agilect in treating Parkinson's have been positive, and several new generics have been approved by the FDA, including Gabapentin (generic Neurontin) capsules for epilepsy, and Ribavirin capsules for hepatitis C. S&P has reduced their 12-month target price to \$31 from \$44, because of what they see as a volatile year ahead. Copaxone will face competition from Biogen's Antegren, and the U.S. generic industry in general may face more competition from India and tougher legislation from our own government. However, the pipeline of new drugs is deep and diversified; and their second proprietary drug, Agilect, which requires only a once-a-day dosage, looks to be a very promising source of revenue. The current low stock price offers a buying opportunity.

FINANCIAL

Capital One (COF \$73, P/E/G .78) – Capital One has reported earnings that far exceeded analysts' estimates in each of the last four quarters, and the company

increased its earnings expectations for 2004 to \$6.10 - \$6.40, well above the consensus estimate of \$5.98. Management's ability to diversify earnings and execute their new plan has been impressive. The company'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. Still the stock is inexpensive with current and forward P/Es of about 11, compared to the industry average of 13.

INDUSTRIALS – Currently no stocks on list.

ENERGY

Devon Energy (DVN \$73, P/E/G 1.80) – Added to the List today

Devon is both an oil and natural gas company, involved in exploration, development, production, and transportation of oil, natural gas, and natural gas liquids (NGLs). They have merged with or acquired other companies once in each of the last four years, buying properties at reasonable prices, and building themselves into the largest independent U.S.-based oil and gas producer. The current estimates of 5% annual earnings growth for the next five years and \$8.47 in earnings for 2005 will probably prove to be on the low side, as are, in my opinion, the current estimates for the prices of oil and natural gas over the next year and beyond. The company is selling off its non-productive and shorter-lived properties and plans to use the proceeds to buy back shares. They also plan a 2-for-1 stock split. The stock price is inexpensive, trading at only 9 times (the underestimated) earnings for 2005. Morningstar and S&P have target prices of \$86 and \$85 respectively.

Nabors Industries (NBR \$49, P/E/G 1.42) – 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. Earnings for 2005 are expected to increase almost 40% over 2004, and Standard & Poor's has increased their 12-month target price to \$60 from \$53, retaining their Buy rating.

Drilling is a high risk business, because of the frequent negative impacts of weather and geopolitical turbulence. However, the current rise in demand for oil and gas, coupled with the depletion of reserves, bodes well for the drilling and oilfield services sector. As Briefing.com puts it, "Rising trends in demand for oilfield services will give companies license to implement price hikes without impeding drilling activity. Services companies had started to see the fruits of these trends back in Q2, which are expected to continue well into 2005." Nabors has enough excess capacity to take advantage of the increased need for drilling, and they are spending some of their recent profits to upgrade their rigs.

RETAIL/CONSUMER – Currently no stocks on list.

CHANGES TO PREVIOUS LIST (8/04)

REMOVED FROM THE GARP RECOMMENDATION LIST:

L-3 Communications (LLL \$66, P/E/G 1.34) – L-3 Communications, a leading merchant supplier of Intelligence, Surveillance and Reconnaissance (ISR) products, secure communications systems and products, avionics and ocean products, training products, microwave components and telemetry, instrumentation, space and wireless products, is removed only because it has reached a fair stock price. It remains a quality long-term investment.

Sell or Keep: Keep

UTStarcom (UTSI \$17, P/E/G 1.06) – The company had a terrible second quarter, going from \$30 to \$17. Management recently announced third quarter earnings, and they provided guidance for the fourth quarter and 2004 that was quite disappointing. Investors have lost confidence in management's ability to execute their plan to diversify their business model and to transform themselves into a global telecom solutions provider. This transition will take time, but management has a great track record, having increased revenues each of its seven years as a publicly-traded company. Global demand for their products is very strong, and they are entering new markets and introducing new products. The company is projected to grow 20% annually over the next five years, and trades at only 10 times next year's earnings, which are estimated to more than double over the disappointing 2004 earnings. Although the stock is attractively valued, there remains risk to buying shares now.

Sell or Keep: Keep. For those willing to be *speculative*, this could be a good buy now.

Panera Bread Company (PNRA \$34, P/E/G .98) – Management reported third quarter earnings and revenue which met expectations, but their eps outlook for 2005 was decidedly below the 30% growth rate previously targeted. Annual revenue growth is still anticipated to be about 28% over the next five years, but profit margins will be less next year, because a greater percentage of new store openings will be company-owned stores rather than franchises, which are immediately profitable. Besides the greater costs of opening company-built stores, commodity prices are increasing too. The company plans to raise prices to offset some of these costs. The stock is attractively priced, and growth remains healthy, if not as robust as last year.

Sell or Keep: Keep. I would actually continue to recommend Panera as a GARP buy, if not for management's handling of the earnings report, which makes me consider it somewhat *speculative*.

ADDED TO THE LIST:

Rofin-Sinar Technologies (RSTI \$29, P/E/G .79) – See Technology above

Devon Energy (DVN \$73, P/E/G 1.80) – See Energy above

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