

QUARTER MARRED BY GEOPOLITICAL RISK

For three months the Dow has been erratic, losing or gaining more than 100 points in one day no fewer than seven times each way. During March the index corrected more than 600 points, about 5.5%. Most of the negative days were the result of terrorist activities or threats of terrorism.

The truth is this first quarter produced very strong earnings reports, which also provided positive guidance regarding future earnings. Except for stagnancy in employment numbers, economic news has supported optimism: evidence of corporate spending on IT and equipment, IPOs coming to market again, and little sign of inflation (although recent prices of oil and gas and commodities like copper, silver, and gold have reached new highs).

But geopolitical risk keeps taking the wind out of the sails of the stock market's performance. Technology stocks have taken the brunt of the beating. Since they typically are awarded higher prices to earnings ratios than the companies of other sectors, the nervous investor has been selling these riskier names and looking for safer investments. The Nasdaq index, which is comprised of predominantly tech and biotech stocks, corrected almost 8% from its high this year to its close on 31 March.

Usually large cap pharmaceutical stocks would benefit from this move away from technology, but this group has had its own problems recently. Will there be changes in Medicare that result in lower prescription drug prices? How will the importation of cheaper pharmaceuticals from other countries play out? If Bush doesn't win, will new legislation squelch the profits of big drug companies?

Bottom line: fundamentals are still good for many quality companies; the outlook for the rest of this year is also good for these companies. But there is no accounting for the odds or impact of the next big geopolitical crisis. Your judgment of this potential is personal.

If your concern is great, you will probably want to reduce risk in your portfolio, eliminating or reducing those holdings that are more speculative or that depend on a robust economy (tech, biotech, consumer discretionary), and add to positions that are more defensive, less volatile, and pay dividends (energy, healthcare, industrials). Since my recommendation list is based on growth, you won't find many conservative, dividend-paying stocks on it. There are some good candidates (BP and ChevronTexaco) in my recent article "Energy Stocks for 2004 and Beyond" on www.fizone.com.

GROWTH STOCK RECOMMENDATION LIST

Regardless of your fear of geopolitical risk, the companies on my growth recommendation list are quality stocks that are generally not very speculative,

and they meet my criteria of being reasonably priced along with their good growth outlook:

TECHNOLOGY

Flextronics (FLEX \$17) – This company not only reported stronger than expected quarterly earnings and revenues recently, they guided substantially higher for the full year. Not included in the new guidance is approximately \$2 billion in potential revenues from a possible deal with Nortel: . . . “a proposed relationship that could turn out to be a major transformational event for Flextronics and become the largest program award in the history of the EMS industry. . . ” according to a recent Businesswire story in which it was revealed that Flextronics is included in the current Zacks.com All Star Analyst Portfolio. To qualify a stock must have a Strong Buy rating from at least five analysts rated 5 Star All Stars.

L-3 Communications (LLL \$60) – L-3 is up about 15% in the first quarter this year and 31% since October when I originally removed it from my buy list in anticipation of the government having to reduce its defense budget. Still it has only a 1.19 PEG based on 2004 earnings; and it is a well-managed company with a steady revenue stream, due partly to its focused business model. They provide secure intelligence, surveillance and reconnaissance systems, simulation and training, and other defense products and are not dependent on big contracts from the Pentagon. In a recent issue of Barron’s, L-3 was featured in the article “Preparing for the Long Haul – Every portfolio needs a few gems that can really deliver over 10 years or longer”.

UTStarcom (UTSI \$29) – This telecommunication equipment company handily surpasses industry peers in return on equity and profit margins, has little debt, is trading at a modest 18 times current earnings, and can be bought for only .7 times 2004 earnings divided by 22% forecasted long-term growth. Its Personal Access System (PAS) technology provides a mobile access network within a city or community, a fairly cheap service that is particularly attractive in developing countries where per capita income and phone line penetration are so much lower than in developed countries. About 30 million Chinese use the PAS as a fixed-line substitute, since they sometimes wait up to 10 years for a home phone. The company is focusing on rapid-growth telecommunications markets around the world, such as India and Viet Nam.

TECHNOLOGY SERVICES

Comcast (CMCSK \$27) – With more than 21 million subscribers, Comcast is the largest cable operator. They have been upgrading the AT&T Broadband cable network they bought in 2002—53,000 miles in 2003—and rebuilding their own cable system to accommodate the roll out of more advanced services such as internet access. Their fourth quarter earnings and revenues far exceeded expectations. Revenues were up 58% year over year and are estimated by S&P to grow 10% in 2004. S&P also expects the company to generate more than \$2

billion in free cash flow in 2004 and maintains their \$39 price target. When you look at the GARP stats on my list, Comcast does not pass the test, because of difficulties with post-merger numbers. But management has such a great track record, I do not think they will substantially raise their bid for Disney or otherwise jeopardize their history of increasing the value of their company.

HEALTH CARE

Biogen IDEC (BIIB \$57) – This recently merged company now has the expertise and infrastructure for both cancer-fighting drugs and auto-immune therapies. Rituxan, the firm's cancer drug for non-Hodgkin's lymphoma, has met its Phase III efficacy endpoint early and will be put on the fast track for FDA approval. The firm is submitting to the European Agency this summer an application for approval of Antegren for treatment of multiple sclerosis. Fourth quarter earnings reported a net loss due to write-offs related to the merger. Standard & Poor's views revenue growth as strong—20% annualized through 2008—and has a \$66 target price.

Cardinal Health (CAH \$69) - This diverse health care company consists of four segments: pharmaceutical supply and distribution, medical and surgical products and services, pharmaceutical technologies and services (PTS=biotech), and automation and information services. Cardinal Health has been aggressively adding to its high-growth manufacturing segment (PTS) through acquisitions—half of its acquisitions in the past three years have been drug development and manufacturing companies, including most recently Intercare Group in Europe. At 21 its P/E is approaching the 21.9 of the S&P 500 Index, and its P/E/G has crept up to 1.20, suggesting it's not undervalued. However, it's a steady grower, increasing eps and net income every year for the last five years. Still a good buy, particularly on dips.

Pfizer (PFE \$36) – Recent FDA approval of two new drugs, Caduet and Spiriva, add two more potential \$1 – 2 billion blockbusters. Caduet is a combination pill (containing Norvasc and Lipitor) for treatment of both high blood pressure and high cholesterol. Spiriva is an inhaler for the treatment of chronic bronchospasms. Pfizer has more than 200 new drugs in development. Meanwhile, its cholesterol-fighting Lipitor showed in a recent trial that its use reduced the incidence of non-fatal heart attacks by 47% versus conventional care. Standard & Poor's price target is \$43.

Teva Pharmaceutical (TEVA \$64) – Teva is the largest supplier of generic drugs, makes bulk pharmaceutical chemicals, and has a successful proprietary drug, Copaxone, an injectable treatment for multiple sclerosis. They recently began marketing their generic painkiller Oxycodone Hydrochloride (OxyContin), with six months exclusivity. Teva is one of the most profitable firms in the generic sector because of volume sales and operating synergies from recent acquisitions. The company currently has generic equivalents of Serzone antidepressant, Wellbutrin antidepressant, Neurontin anticonvulsant, Monopril and Accupril antihypertensives, and Ribavirin antiviral agent. S&P expects

revenues to advance over 20% in 2004, sees Copaxone sales increasing 15%, and assigns a 12-month target price of \$78.

FINANCIAL

Capital One (COF \$74) – Even though this credit card issuer is up about 150% since I first recommended it 15 months ago, its P/E/G is still under 1.00, its long-term growth is estimated at 16% annually, and earnings for 2005 are projected almost 15% higher than 2004. The company has switched their customer focus from the sub-prime segment to the super-prime segment, which will lower loan growth, but also decrease delinquency and loan loss, while credit quality improves. Capital One recently reported credit losses at 4.75%, the lowest level in 18 months; delinquencies continued to improve, falling to 4.14%. Standard & Poor's has a target price of \$85. This stock has a history of volatility—it could get cheaper before reaching new highs—but I think management will use their cost efficiency and customized approach to acquiring customers to continue their excellent track record.

INDUSTRIALS – Currently no stocks on list.

ENERGY

Nabors Industries (NBR \$45) – Nabors is the largest oil and gas land drilling contractor, mostly in the U.S., but also internationally, with some offshore rigs, primarily in the Gulf of Mexico. Since most of its rigs drill for natural gas in America, and natural gas is expensive to transport, Nabors is conveniently located near the largest gas market. The biggest risks to drillers are that they depend on high commodity prices and depleting deposits of that commodity. Consensus is that natural gas prices will stay high through 2004, and that drilling activity has not yet reached its peak. In fact, low inventories and high commodity prices are currently prompting the exploration and production companies to increase spending, benefiting the drillers. Standard & Poor's has a 12-month target price of \$53.

Pioneer Natural Resources (PXD \$31) – added to the list today. This independent, mid-cap oil and gas exploration and production company operates in the U.S., Canada, Argentina, and several African countries. U.S. operations are mostly in Texas and the Panhandle, with deepwater exploration drilling in the Gulf of Mexico. Pioneer recently announced it expects production for the first quarter to come in at the high end of the range it announced in February: about 180,000 to 183,000 barrels per day. Production is expected to increase 15% in 2004 over the 56.5 million barrels in 2003. During this period of high commodity prices the company has maintained a conservative financial strategy, replacing reserves at economic costs. For these reasons Standard & Poor's has raised their rating to Buy with a 12-month target price of \$38.

RETAIL/CONSUMER

Panera Bread Company (PNRA \$42) – These bakery-cafes specialize in high-quality food for breakfast and lunch, with 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. They have about 150 company-owned bakery-cafes and more than 400 franchised bakery-cafes. They intend to open 100 – 150 annually for the next several years. Annual revenue growth is anticipated to be about 23% over the next five years. Standard & Poor's has a 12-month target price of \$48.

Sharper Image (SHRP \$32) – This micro cap specialty retailer is a paragon of consumer discretionary stocks, and it plunged about 18% in the March sell-off from its high of \$39. The fundamentals are still good: zero debt, projected 20% annual growth, and P/E/G and price/sales ratios under 1. Same-store sales for February were up 20%; total sales up 47%. For the third month in a row the company has raised earnings guidance. They have reached their goal to add 25 new stores in 2004. In February I left this stock on my buy list, but with the caveat that share price may struggle against the "overvalued" call. Now its valuation is again reasonable, but could still be vulnerable in a nervous market.

CHANGES TO PREVIOUS LIST (2/04)

Two companies, Laboratory Corp. of America and Outback Steakhouse, have been **removed** from the Recommendation List:

HEALTH CARE

Laboratory Corp. of America (LH) – Lab Corp. provides clinical diagnostic testing services through a national network of laboratories for more than 200,000 physicians and other health care providers. I am removing it only because CEO Thomas MacMahon has guided growth down to 11% to 13%, indicating that pricing competition has increased because of new, smaller competitors hoping to be acquired. "We see more laboratories getting into the business with the ultimate goal of getting out of the business," he said. Standard & Poor's has lowered their target price for the company to \$46. If you own it, you could sell it to use the proceeds for something else. I don't think the stock is at risk, just on hold.

RETAIL/CONSUMER

Outback Steakhouse (OSI \$49) – This chain of casual dining restaurants has superior operating history, excellent expansion prospects, and a sound balance sheet. They have historically been able to increase same-store sales during tough times, and the company has increased revenues for the last 10 years. However, I can no longer recommend buying at their current price, a significant premium to peers. The stock is up 29% since I added it to my list in October. If you own it, keep it.

Added to the list was: ***Pioneer Natural Resources.***

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