

## ***BUY STOCKS FOR GROWTH, BUT BE CHOOSY***

The stock market has rallied 13.5% since my April Growth Stock Recommendation List, and my recommended stocks averaged a 21% increase in that time. This is good if you bought these stocks then, but it is difficult to continue to recommend them with as much confidence in their upside potential. Consequently the list is a little shorter, with fewer blue names.

The strategy of my picks list, growth at a reasonable price (GARP), has become even more important. The [Blue List](#) stocks are excellent buys now. The non-blue stocks either have less-stellar growth prospects or we have to wait for some price decline or increased growth in revenues and earnings.

I think the market will continue upward, as our recovery progresses. One sign that this rally is real is that there has not been a big profit-taking sell-off, as there has been with previous rallies over the last year. Also encouraging is continued GDP growth, even as unemployment has not improved. As consumer confidence and spending improve, the rest of the cycle will proceed, including renewed hiring.

### **CHANGES TO PREVIOUS LIST (4/03)**

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

**Biogen** – I added Biogen to the list in April, because I liked the outlook for biotech—I still do—and the company had just received FDA approval for Amevive (psoriasis treatment) and raised their guidance for 2003 earnings. Since that time they received FDA approval for the pre-filled syringe for Avonex (multiple sclerosis treatment), the stock price went up 35%, and analysts have subsequently lowered their 5-year growth outlook from 15% to 13%. The latter two result in an over-priced stock. In an industry of so many competitors and so much risk, I do not find this company attractive now. If you own Biogen, I would recommend selling it and switching into a more promising biotech stock. (Selling Biogen may not be a choice or may not be beneficial in your specific circumstances, which must be considered.)

**Eaton Vance** – Similarly to Biogen, this stock was added in April, because I liked its niche (tax-managed investment funds); since then its price has increased 15%, and analysts have lowered the 5-year growth outlook from 15% to 13% and the 2003 earnings estimate from \$1.63 to \$1.53. These ingredients add up to a stock that has become expensive and lost its growth appeal. Depending on your cost basis and circumstances, you may want to sell this stock.

**Global SantaFe** – Estimates for 2003 earnings and the 5-year growth outlook continue to come down for this oil driller, while analysts continue to accentuate the positive: higher estimates for 2004 due to the perennially anticipated second half recovery, which will lead to more demand for oil, benefiting the drillers. Meanwhile the stock price has increased 18%, resulting in a P/E/G over 3. I like the stock, but it's way too expensive to recommend buying at these levels. If you own it, it is probably worth holding.

**No longer blue:** Many companies on my list have had huge price increases since the April list, bringing the “reasonable”-ness of their prices into question. More than 20% of those I considered for the list have made new 52-week highs, including four of the 22 that made the list.

**Lennar** – I am removing Lennar from the Blue List, even though it still meets all of the GARP criteria. It is now at a new 52-week high and more than 20% higher than it was in April, a trend I normally embrace. However, I also make my recommendations with the long-term in mind, and I believe, when interest rates go up—which they will—homebuilding will begin to decline. This company is still a good buy, but should be watched closely over the intermediate-term.

**Home Depot** has consistently grown revenue over the years—30% annually in the 1990s—but they lowered their guidance for 2003 to 9-12% sales growth. Only because the company has matured and is not likely to provide 14%+ annual growth have I removed it from the Blue List. Management has improved customer service and remodeled stores, both of which helped the company to improve same-store sales more than its largest competitor (Lowe’s) in the second quarter. This company remains a core holding with decent growth for years to come.

**Added** to the list was:

**Kinder Morgan** – This company gets 90% of its income from natural gas pipelines. It owns the partnership that manages Kinder Morgan Energy Partners (KMP) and 19% of that company. CEO Richard Kinder was COO at Enron until 1996, after which he founded Kinder Morgan. He was not involved in Enron’s demise, and at Kinder Morgan he receives only a \$1 annual salary, his wealth coming entirely from the increased value of KMI and from distributions from his stake in KMP. In addition to good management, the energy infrastructure it owns provides substantial free cash flow. The stock is at a 52-week high, and the company has more debt than I like; so I would look to buy it below \$50.

## **STOCK BY STOCK COMMENTS**

**Flextronics** has increased revenues in each of the last five years, even though a portion of their customers are in the tough telecom industry. They are the largest contract manufacturer, and they offer a wide range of services, which positions them well for that elusive return to capital spending by hardware companies. S&P sees 2004 operating EPS up 23%. This stock should take off on any signs of increased capital spending.

**L-3 Communications** – This technology company supplies sophisticated secure communication systems and specialized communication products primarily to agencies of the U.S. Government. L-3 meets all GARP criteria, and S&P expects “sales to advance 18% in 2003, primarily due to new revenue generated by acquisitions.” Even with the war behind us, these are the kinds of products a strong defense budget will be earmarked for.

**Western Digital** – Security and storage are the bright spots in technology now. This mid-cap technology company makes and sells hard disk drives (for storage) for a wide

range of computers, servers, and networks. They also make the hard disk drives for Microsoft's X-box gaming system, one new market the storage maker is pursuing to increase revenues. S&P expects revenues to grow 25% in 2003 and 12% in 2004. In 2002 revenues increased 10% from basically flat in 2001. They are headed in the right direction, and industry consolidation should boost market share and improve the pricing environment. This stock is well-positioned when the technology sector is revitalized.

**ADP** - This payroll processor has a long history of increasing EPS; it still has some growth potential, but low interest rates and rising unemployment have combined to thwart earnings in 2003 and most likely into 2004. This is a great company, with competitive advantages and a market share duopoly (with Paychex); it's priced attractively and should reward long-term investors as employment and interest rates pick up.

**First Data**, which owns Western Union, is a leader in credit card and money transfer processing. They recently acquired Concord EFS and its STAR, MAC, and ATM cash station networks, which will enhance First Data's fee income stream. S&P expects revenues and earnings to each grow about 15% annually for the foreseeable future. Revenues have increased each of the last five years, and the stock price recently reached a new 52-week high. I would look to buy below \$40.

**Cardinal Health** gets most of its revenues from its pharmaceutical distribution division; but it is a diverse health care company. It manufactures drugs and medical supplies, develops drug-delivery technologies, and offers services that make health care more efficient. It has increased annual sales each year for the last six years and has excellent fundamentals all-around. With low debt and earnings projected to grow 19% annually for 5 years, this stock is blue.

**Idex Pharmaceuticals** – This biotechnology company develops and makes immunotherapeutic and cancer-fighting products, two of which, Rituxan and Zevalin, are used for the treatment of non-Hodgkin's lymphomas. Rituxan was the first monoclonal antibody approved for treatment of cancer, and it is now the standard. Zevalin is the first approved radioactive monoclonal antibody. The growth potential for these two drugs is substantial. Two concerns are the negative impact of Medicare reimbursement policies on Zevalin sales (at \$17,000 per dose), and the success of the new manufacturing facility, which has impinged on free cash flow.

**Pfizer** has a strong product line: Lipitor (cholesterol-lowering), Zoloft (anti-depressant), Zithromax (antibiotic), Viagra (we all know what for), Zyrtec (allergy), and from Pharmacia's arsenal—result of their recent merger—Celebrex (arthritis). The two combined now have 10 drugs that each provides more than \$1 billion per year in revenue, and several blockbusters (Lipitor, Viagra, and Celebrex) that are patent-protected for seven or more years.

**Teva Pharmaceutical** – The only reason Teva is not blue is its somewhat high P/S. Teva manufactures generic drugs, many of which are awaiting FDA approval. They should be beneficiaries of upcoming patent expirations at the big pharmaceutical companies and the trend to use cheaper, generic drugs. Their products include generic equivalents of Glucophage (diabetes), Augmentin (antibiotic), Remeron (antidepressant), and Zanaflex (muscle spasticity). One caveat: they are based in Israel.

**WellPoint Health Networks** – Even though this stock is up about 11% since April and 31% since being added to the list in February, it still meets all the GARP criteria. It offers a diverse mix of managed healthcare products, including an HMO, a PPO, and other hybrid plans. S&P expects premium revenues to grow about 15% in 2003 from enrollment growth. They have flexible deductible and co-pay plans, which give them a competitive advantage.

**AIG** – This financial services conglomerate specializes in insurance, an industry of many competitors. AIG's two biggest plusses are its foreign insurance businesses and its CEO Maurice Greenberg, who is 76, but has no plans for retiring soon. Less competition overseas has helped with AIG's growth and profits, as has the company's strong management. This company has a long history of solid growth, which should continue, even if more modestly than that of true growth stocks.

**Capital One** has been a remarkably profitable credit card issuer, primarily due to its information-based strategy. The company tests products, processes, and consumer behavior to guide strategy. They are currently shifting their focus away from sub prime lending to the prime and super prime markets, where competition is greater, but charge-offs are fewer. Risk is inherent in a company that extends credit, but Capital One has had a low charge-off rate, indicating their research has paid off. Capital One's stock price is up 50% since the April list.

**Fannie Mae** - As a provider of liquidity for residential mortgage investing, Fannie Mae may see a considerable slow-down over the next year as refinancing diminishes. But this company has an excellent record of increasing revenue each year, and S&P expects a 9% increase in revenues for 2003. Like other solid companies mentioned in this list, growth may not be flamboyant, but will most likely continue to be in the low double digits.

**General Dynamics** - This defense company has excellent fundamentals: low debt, a history of increasing revenues, a diverse revenue source, and a return on equity of at least 15% for each of the last ten years, a time in which U.S. defense spending declined. Defense spending is expected to increase 6% annually over the next five years. And now GD has added homeland security and government IT to its repertoire by acquiring Veridian Corp, which it expects will add to this year's earnings.

**United Technologies** - UT's solid management team sticks to strengthening its four major businesses: Otis elevators, Carrier heating and air conditioning, Pratt & Whitney jet engines, and Sikorsky helicopters. Revenue growth was hurt in 2002 because of weakness in the airline industry, which reduced demand for its jet engines. According to Morningstar, "prudent acquisitions--along with effective cost-cutting--have enabled the firm to increase earnings per share 18% annually over the past nine years. In addition, this firm's businesses generate a lot of cash, which the company uses to pay dividends, buy back shares, and invest in research and development. This is a great long-term investment.

**Autozone** is the national leader in retail auto parts and has increased revenues in each of the last ten years. The company should continue to be driven by the do-it-yourself culture and the growing number of aging autos. S&P sees revenue growth in the mid- to high-single digits for the next several years, and "Long-term prospects should be aided

by a rising number of aging motor vehicles in their prime repair years, and by increased vehicle usage." The stock price is up 10% since the April list.

**Costco** has increased its revenues every year for the last ten years, and sales have grown 10% annually over the last four years; it is estimated to grow annually at least that much for the next five. Costco's stock price has increased more than 13% since April, sending its P/E/G to 1.83. This is an exceptional retail company whose model works, e.g. membership fees and discount prices, making it a great long-term investment. But the company is maturing and topline sales growth is slowing. A dip below \$30 would be a buying opportunity.

**Sharper Image** – May same-store sales increased 19%, and in-store sales increased 31%, much better than analysts expected. Internet sales increased 39%, an indication that their catalogue business is accepted by consumers. The price is up 25% at the time of this writing since April's list. Still the P/E/G is under 1.00, making this boutique retailer a GARP candidate for sure.

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