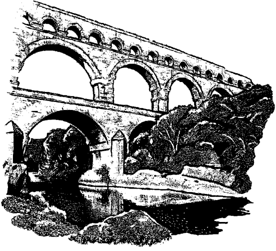

Stanley E. Rulapaugh, CFA **July 1, 2000**

Buy low, sell high.

Wall Street axiom seldom exercised by Wall Street.

It has been a strange six months. The popular averages are all down for the year with the Dow Jones Industrial Average leading at a minus 10%, largely because the index holds a larger component of cyclical stocks. Technology had a roaring few weeks at the beginning of the year but by mid-April the roar had turned into a squeak. Certainly some issues continued to do well. Hewlett-Packard, General Electric and Intel come to mind but a large number of the technology and internet issues are flat or down. This last week we learned from the *Wall Street Journal* that there are financial risks in some of the favorite internet giants, specifically Amazon.com and YAHOO! With the unlimited support of Wall Street analysts, these two companies raised billions in the capital markets to support profitless growth, spending other people's money like there was no limit. Favorable research reports propped up Amazon and YAHOO! prices in hopes of generating additional underwriting fees. The higher the stock prices, the more favorable the research reports became. Until recently. Amazon stock peaked at $113 on December 9, 1999 but has been falling to a low of $32 just a few days ago. Now there are questions about Amazon's revenue growth, negative cash flows and deteriorating credit quality, all signs of a company in distress. So far, the questions are only questions but the stock price shows something is going on.

YAHOO! faces the same problem because the company relies on internet advertising for revenue. Since most of the ads on the internet are for ".com" companies, many of which are in financial distress themselves, there could be a slowing in advertising expenditures which means that YAHOO!'s revenue will slow as their ad revenue slows. I doubt that Clorox and Whirlpool, for example, will spend money on internet advertising in sufficient quantities to replace failed/failing internet companies.

After a stock falls out of favor, for any reason, Wall Street analysts invariably abandon the stock, usually en masse. "Abandon" is not the right word. Analysts are the people who go out on the battlefield to bayonet the wounded. Back in January 1999 Eli Lilly stock was selling at $87, near an all-time high of $97. The analyst for SG Cowen rated the company a "1 (strong buy)" because of "wide-ranging earnings per share possibilities through 2002." All of the pharmaceuticals stumbled and Lilly dropped to $59 by March 2000. The same analyst's conclusion, after being on the wrong side of the market for fifteen months, was "we believe the stock is unlikely to outperform the sector until pressure [on Prozac] subsides . . . We rate LLY a 3 (Neutral) for a 12- to 18-month price target of $66." The new target was $21 <u>less</u> than the stock price when he produced his prior "strong buy" rating. Two days ago Eli Lilly announced a successful test of a drug to fight sepsis, an often fatal disease that kills fourteen hundred people every day. Eli Lilly stock, up substantially in the last three months, soared another $15 a share to $103 on June 29.

Honeywell International, a company with a strong local presence, fell out of bed two weeks ago when management disclosed an earnings estimate that was below that which the analysts thought possible. The stock dropped from $52 to $33 because second quarter earnings would be "between $.73 and $.77" rather than the $.77 to $.78 that Wall Street analysts expected. That's $.05 for 25% of the year when the company is expected to earn more than $3.00 for the entire year. While I don't think a nickel is very much, obviously somebody does. Honeywell is one of our highest quality companies with a place in the Dow Jones Industrial Average. The company had "strong buy" recommendations from eleven

analysts a month ago with none recommending "hold." Today only seven analysts rate Honeywell a "strong buy" with two now rating it "hold." Evidently, the lower the price the worse the investment opportunity. Selling of Honeywell has continued for the two weeks since the announcement as some portfolio managers try to rid themselves of the company before the end of the June quarter. The huge volume of shares is being absorbed by value managers in search of a bargain.

Staples, Inc., a specialty retailer, has been a favorite target of mine since all three guest analysts on *Wall Street Week with Louis Rukeyser* thought it was a buy at $30 eighteen months ago. In March 2000 when the stock was $20, eleven out of twenty-one analysts rated the company a "strong buy." Now that it is $15, only six out of sixteen rate it a "strong buy." Five dropped coverage of the company.

A little over a month ago, a Morgan Stanley Dean Witter analyst reduced the rating on Costco Wholesale precisely at the 52-week low because company spending to strengthen the company's long-term growth prospects will hurt short-term earnings. Consider the time horizon used in the analysis.

> We believe slower growth in the fiscal fourth quarter (August 2000) and only 11-13% earning-per-share growth in [estimated fiscal 2001] will keep a lid on the stock's near-to intermediate-term valuation, postponing upside potential in the shares well into the fall. We believe COST can regain its valuation premium to the market when the benefits of current investments become more visible.

In other words, sell Costco now and buy it back in six months when the new stores are opening. Costco sells an average of $90 million per retail outlet with plans to open eleven stores this fiscal quarter and another 35 to 40 stores in fiscal 2001. That works out to about $3.5 billion in incremental sales going forward. Why isn't this low price a buying opportunity in anticipation of the new growth to come?

Portfolios need to be refreshed occasionally and waiting for the last eighth or quarter point to get out at the high can be costly. Taking profits when profits are good (and paying taxes) is part of the process. I was reminded of Winnie the Pooh when the bear tried to get the last little bit of "hunny" out of the bottom of the jar. Even though Pooh was successful getting all of the "hunny," he was not able to get his head out of the pot.

The Federal Reserve has raised interest rates six times in the last year in an effort to scare a sufficient number of investors which may slow the economy. Unless we get into a full-blown recession, which I doubt, many of the economically sensitive stocks are real bargains. Why? We know the Fed won't raise rates forever. Banks and retail will snap back. We know that businesses adjust to adversity or they get acquired by another company that can adjust. Lilly Industries, one of the leaders in industrial coatings was $13 when Valspar, another paint and coatings company, announced that they wanted to buy Lilly for $31.75 a share. It is cheaper to buy than to build. We know that even the most mundane company can discover something special. Consider Perkin Elmer morphing into PE Biosystems and Celera Genomics and Eli Lilly's wonderful new product for sepsis this week. We also know that a terrific company can fall on hard times for any number of reasons. Consider Microsoft and Qualcomm. Sometimes selling a few shares of a big winner at a high price to take advantage of an out of favor stock at a low price is the best strategy.

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