MARKET STRATEGIES

Many stocks are still too high

By Randall Abramson

Stock markets everywhere have endured a serious correction. From their highs, the NASDAQ is down 38 per cent, the S and P 500 is off 11 per cent and the TSE, which was earlier this year the best-performing market in the world, has declined 19 per cent. Since March, the investment climate has been really lousy, and we don't see any immediate improvement on the horizon.

The last three years were characterized by easy money, falling interest rates and a buoyant economy with robust and consistent growth. In that kind of friendly period, an investor can afford to be aggressive.

When central banks, lenders and Wall Street are loose with money, stocks rise, sometimes to absurd levels. And when IPOs can triple on the first day of trading, even throwing darts at the stock page can be rewarding.

This is no longer the case. We now have tighter money – central banks are reining in money-supply growth, banks aren't lending as freely and the high-yield markets are in disarray.

Interest rates, particularly at the short end where the central banks have the most control, have been rising. The economy is slowing and competition is intense. Sales are harder to generate and companies vie for market-share, pressuring profit margins.

The markets have enjoyed nine straight years of corporate profit growth. If revenue growth slows and margins erode, we could have a period where profits decline much like 1989 to 1991, where earnings fell each year. We continue to believe it's a time to be very cautious.

Most are still ignoring the danger signs. Most pundits believe that valuations are now compelling, given the declines in tech land and that the economy is in good shape. But we have recently witnessed too many disappointing quarterly releases.

Dell, **Home Depot**, **Apple**, **Motorola**, **Lucent**, **Circuit City**, **Best Buy**, **Stelco**, **Intel**, **Microsoft**, and others throughout a cross-section of the economy, have all signalled a slowing in their businesses.

We think it's all about valuations. And too many stocks still have unsustainable, high valuations. Sure, stocks like **Oracle**, **Cisco Systems**, **JDS Uniphase** and **Nortel Networks** are way off their highs; yet each of these companies has a good way to fall before reaching 'fair value'.

Close attention must be paid to the valuations and earnings sustainability of what you own.

We suggest investors build cash balances and develop a list of great companies to buy when their stock prices become bargains. In the meantime, buy only those stocks that are ridiculously cheap – those that should hold up in a bear market. Try to buy companies with less economic sensitivity.

If you have the temperament, sell short some overvalued stocks, particularly where the business seems flawed or vulnerable to competition and the weakening economy.

In our managed accounts we are long very cheap stock, short very expensive ones and hold cash and high-yielding income securities that we think will weather the storm. On the long side, we like a number of stocks, including:

Jones Apparel Group (JNY-NYSE, $29.38, 215-785-4000, *www.jny.com*), an apparel wholesaler and retailer that is superbly managed, is growing its earnings by 20 per cent per year, has solid margins, great brand names including Jones of New York, Evan-Picone and Nine West, and sells for only eight times earnings (about one-third the market multiple);

Canadian Natural Resources (CNQ-TSE, $44.15, 403-517-6700, *www.cnrl.com*), the third-largest oil and gas company in Canada – it is a perennial winner, has grown its production four-fold in the last three years, has good natural-gas exposure at a time when shortages might occur due to possible critically low U.S. inventories this winter, and that trades for only eight times earnings, or three times cash flow, using conservative commodity pricing assumptions (annualizing its latest quarter, it's trading at 5.5 times earnings, or two times cash flow, well below historical norms);

Hurricane Hydrocarbons (HHL.A-TSE, $9.30, 403-221-8435, *www.hurricane-hhl.com*), an oil company that trades at, unbelievably, only two times earnings, is a vertically integrated producer in Kazakhstan with finding costs less than one-third those in North America, will be essentially debt free by year-end, is well managed by CEO Bernard Isautier, the former head of **Canadian Occidental Petroleum**, and even, though it's a relatively large producer at 90,000 barrels per day, is relatively unknown.

Short selling ideas, so you can profit from declines in stocks and hedge long positions, include:

Amazon.com (AMZN-NASDAQ, $30, 206-266-1000, *www.amazon.com*) – the company has a market valuation of $11 billion, with $2 billion in debt, and has not yet come close to turning a profit. It only has about $700 million cash left, which is likely to last no more than 18 months at the current burn rate;

E*TRADE (EGRP-NASDAQ, $12.75, 650-331-6000, *www.etrade.com*), an online broker that is barely profitable, was unable to make money in the greatest bull market of all time and trades at 40 times expected earnings ("expected" by the analysts but not by us, given our outlook);

Juniper Networks (JNPR-NASDAQ, $170, 408-745-2000, *www.juniper.net*) – a great company that is trading at an extraordinary valuation of $55 billion (despite only $800 million in annualized sales), 200 times next year's earnings, 580 times trailing earnings and more than five times our estimate of its true value.

We also recommend holding a few income securities to protect portfolios while you wait for lower equity prices, such as:

Gulf Preferreds (GOU.PR.A-TSE, $3.50, 403-233-4000, *www.gulf.ca*) – yielding just under nine per cent, these preferreds are floating-rate, tax-effective, and recently had a rating upgrade, as the company is reaping the rewards of higher oil prices and an improving balance sheet with the recent **Crestar** merger;

Residential Equities REIT (REE.UN-TSE, $11.35, 416-869-3003, *rereit.com*) – yielding nine per cent, with opportunity for the yield to rise as cash flows from this well-run Canadian apartment owner continue to grow;

Sunglass Hut Convertible Debentures (RAYS-NASDAQ, $77, 305-461-6100, *sunglasshut.com*) is yielding more than 15 per cent, an unusually high return for a low-risk investment – it has only a three-year term, essentially the only debt of the company, and interest expense is covered eight times by annual earnings that have been consistent and relatively stable.

Randall Abramson, CFA, is a portfolio manager with Strategic Capital Partners Inc. and Strategic Advisors Corp. He and these firms might have an interest in securities mentioned. ¶

© Copyright 2000 by MPL Communications Inc., Reproduced by permission of *Investor's Digest of Canada*, 133 Richmond St. W., Toronto, ON M5H 3M8