

ValuEngine View December 2005 Issue

The *ValuEngine View* model portfolio really hit its stride again in November, rising 7.4% for the month. That compares very favorably with the S&P 500, which was up a respectable 2.9%. Anytime the model more than doubles the return on the broader index, it is cause for celebration. Indeed, this harkens back to our very similar results in May and June of this year. Since inception (seven months) the model portfolio is up about 36%.

Most of the holdings showed positive results, led by a 25% gain in FTO. As copper prices hit record highs so did PCU, with a gain of 18%. And SPIL benefited from a wider recognition of its low valuation relative to the rest of the semiconductor industry.

The biggest disappointment was NX, which announced good results for the most recent quarter but lowered forecasts for next year. TEO shares also fell almost 10% but there was no material change in the company's outlook. The model suggests retaining it.

November Results

Company Name	Symbol	Opening price	Closing price	% Gain/Loss
Aegon NV	AEG	\$15.80	\$16.42	+3.9
Cable & Wireless	CWP	\$6.47	\$6.12	-5.4
Emulex	ELX	\$19.48	\$20.44	+4.9
Frontier Oil	FTO	\$32.17	\$40.29	+25.2
King Pharmaceuticals	KG	\$15.40	\$16.77	+8.9
Meritage Homes	MTH	\$59.40	\$69.45	+16.9
Quanex Corp.	NX	\$57.15	\$50.97	-10.8
Southern Copper	PCU	\$58.49	\$68.92	+17.8
Real Networks	RNWK	\$8.04	\$8.22	+2.2
Silicon Precisionware	SPIL	\$4.94	\$5.94	+20.2
Telecom Argentina	TEO	\$14.08	\$12.79	-9.1
Toll Brothers	TOL	\$34.18	\$37.62	+10.0
Tesoro Petroleum	TSO	\$53.84	\$58.06	+7.8
TXU Corp.	TXU	\$47.61	\$53.63	+12.6
U.S. Gypsum	USG	\$58.39	\$62.05	+6.3
Portfolio Average				+7.4%
S&P 500				+2.9%

December's turnover is about average and somewhat lower than we had in November. The model is retaining eight stocks and replacing seven. The seven new holdings are highlighted with a ➤ below and are listed first, followed by the eight being retained from November.

- CompuCredit (CCRT) is a sizeable player in the credit card business, but in a somewhat unusual way. The company issues credit cards to primarily sub-prime consumers, buys up receivables from other card issuers, and has a "micro-lending" business that issues small loans to higher risk consumers through retail storefronts. The company recently completed a new debt offering of convertible securities in order to fund new acquisitions of low quality credit card portfolios. Earnings are expected to grow 38% next year to over \$4/share and revenues should be higher by 30%. But even with this high-growth profile, CCRT shares are valued at roughly a 25% discount to their peers' based on 2006 earnings multiples. This discount is probably attributable to fears that an economic downturn would disproportionately impact CCRT's customer base, but the company has a good history of managing its risk exposure and effectively collecting on bad debts.



- Who would have guessed that there was a shortage of truck tires and that it could have such far-reaching implications? But that is what caused shares of Fording Canadian Coal Trust (FDG) to slump recently. Last week the company, a large Canadian coal-miner, announced that a shortage of truck tires would limit its production capacity next year. In turn the stock took it on the chin, dropping 8% in one day before coming back a bit. At this point shares trade at about 9 X 2006 earnings while coal mining competitors' stock changes hands at anywhere from 12 to 19 X 2006 earnings. Even with the tire impact, earnings at FDG are expected to jump 12% next year. But more important is the fact that FDG's structure as a trust calls for a whopping big dividend. The yield at this point is about 15%, meaning investors are paid well for holding the stock.



- Goodyear Tire (GT) is a name familiar to most investors, and for that matter, to most consumers. The company has been a turnaround story for some time but it appears as though shares are still undervalued relative to GT's prospects. The company has negotiated better terms with its labor force, reducing its break-even point and improving operating margins. GT has beefed up its marketing and branding efforts (having hired two former Proctor & Gamble execs as division heads) and sales are up 10% over the past year. The two biggest worries are a high level of debt (and higher interest rates) and a new labor contract negotiation in 2006. Plans to shift more production to Asia may give GT greater leverage in those negotiations. GT trades at 11 times next year's earnings, significantly less than other tire companies. And as was noted above, there is certainly strong demand for heavy-duty truck tires.



- There has been considerable talk about a global oversupply of steel and that helps explain, at least in part, why Mechel Open Joint Stock Co. (MTL) trades at

such moderate prices. MTL is a Russian firm that operates in both the mining and steel production sectors. Mining results (iron ore and coal) have been strong and steel has been a bit of a drag on the income statement. That should change in the near-term as MTL has added raw material processing capacity and will be able to supply iron ore pellets to itself rather than paying outside sources as it has had to do in the past. Generally MTL's steel production is less efficient than many of the world suppliers but the company is upgrading its operations. Also supportive of the stock will be increased construction within Russia, as higher energy prices have boosted domestic spending. Sales over the past 12 months are 52% higher, double the industry average of 26%. The current PE is 3 versus the industry average of 8.



- Powerwave Technologies (PWAV) is deeply involved in wireless telephone infrastructure products - - towers, antennas, amplifiers, and the like. As companies throughout the world roll out the latest wireless standard, called 3G, PWAV is poised to generate significant increases in revenues and earnings. Helping is the fact that PWAV has made a couple of acquisitions that give it more muscle in the marketplace. Finally, PWAV has a new product cycle underway that is geared toward upgrades, reducing reliance on new tower construction. At 19 X next year's earnings PWAV is not exactly cheap. But the industry average forward PE is 21 and the group is expected to see growth of 18%. Compare that to PWAV's 35% expected growth rate for next year and the company valuation suddenly looks a lot more reasonable.



- Back in August/September our portfolio made a decent profit in iron ore producer Companhia Vale do Rio Doce (RIO). Shares hit a 52 week high at the beginning of this month but have pulled back a bit since then. Revenues are expected to continue rising next year, even after a 50%+ pickup in sales in 2005. As we wrote last summer, RIO trades for a small price relative to its earnings, particularly as we look out into 2006. The forward PE using 2006 estimates is 8. The company recently weathered careful antitrust scrutiny regarding the purchase of several smaller miners in 2000 and 2001. While it was not a complete victory, it now appears that RIO's acquisitions will be allowed to stand. Finally, a number of analysts have pointed to Brazil's stock market as one of the best places for investors in the months ahead, and RIO provides exposure to that market.



- After one of our oil refiner holdings, Forest Oil, jumped over 25% last month, the model suggests we drop it in favor of Valero (VLO). Shares are valued at a

discount, with a forward PE ratio of 7.8 compared to other pure-play refiners that trade more typically for 9 or 10 times next year's earnings. One reason may be uncertainty surrounding the company's recent acquisition of competitor Premcor. But at least some analysts see that as a catalyst for higher earnings. As noted in this space before, it is rare to find companies trading at such low forward earnings multiples and that are also expected to see growth in the coming year. In the case of VLO, that growth is pegged at around 8%. Even if VLO shares traded at a relatively low multiple of 9 X 2006 earnings of \$14.64, that would imply a share price of over \$130. Shares are scheduled to split 2 for 1 on December 16.



- Aegon NV (AEG) has been in the portfolio for longer than any other holding. During that time the share price has improved slowly and steadily such that an investment would now be worth about 18% more than in July. AEG is a large international insurer, based in the Netherlands, but with sizeable operations in the U.S. (under the TransAmerica name) as well as Europe. While the company is not a fast-grower, shares in AEG look inexpensive. The current PE is 9 versus the industry average of 14. The price-to-sales ratio is 0.53 versus the industry average of more than 1. The price-to-cash flow ratio is 9 versus the industry average of 12. Operating margins are a little thinner at AEG than for the average insurer. But the firm is repositioning itself, expanding in Asia and central Europe while selling off its Spanish insurance operations last quarter. If there are signs of those plans being well-executed, earnings estimates for 2006 will continue to climb and shares along with them. And in the meantime, there is a 3.3% dividend being paid.



- Our model's perseverance in holding on to Meritage Homes (MTH) paid off last month, as shares rallied from what was an arguably overdone sell-off. To be sure, shares are still underwater from when the stock was first added to the portfolio in September. But Meritage stands out among the homebuilders as 1) having noticeably stronger sales growth of 47% over the past 12 months compared to 17% for the industry; and 2) one of the lowest PE-to-growth ratios in the industry, currently 0.22, using next year's expected earnings growth of 27% and a forward PE of 5.9. Indeed, there is no large-cap conventional homebuilder with a higher earnings growth rate expected for next year. If it's true that investors are willing to pay a premium price for earnings growth, you wouldn't know it from the multiples on MTH. Indeed, it appears the stock trades at a significant discount. To be sure, earnings are expected to flatten in 2007, and the expectation of rising interest rates has put all the "homies" into a tailspin, but looking out at the near-term, the stock continues to seem attractive.



- RealNetworks (RNWK) is a good news/bad news sort of story. This maker of media software and, more recently, purveyor of digital media, has a 2005 PE ratio that would be the envy of any value investor. Using estimates for this year, RNWK shares trade at about 6 X. That's the good news. The bad news is that earnings are expected to fall next year by a whopping 40%. Investors like to pay for growth, not for shrinkage. However, it is worth noting that even with those lower earnings, the forward PE ratio for 2007 is still low at 9. RNWK will be the recipient of some serious cash, \$750M, courtesy of Microsoft, as part of an antitrust settlement announced last month. Indeed, a recent article in Barron's suggested that RNWK might have \$5/share in cash by the end of next year, and this on an \$8+ stock. That's the good news. The bad news is that RNWK has entered a brutally competitive marketplace selling video and songs online. Apple and Yahoo both have similar offerings and it will be hard to make a buck. But overall revenues are growing smartly and shares look like they are worth more than current prices.



- Siliconware Precision Industries (SPIL) offers an interesting play on the semiconductor business. Despite generating robust sales and earnings, shares of SPIL (based in Taiwan) have not benefited commensurately. Looking back one year, the stock price is presently about 60% higher, however, earnings for the most recent quarter were almost 100% higher than the third quarter of last year. On a valuation basis, this disparity has created a situation where SPIL trades at a 30% discount to its peers using PE. Moreover, using price-to-cash flow measures, SPIL has a 21 X multiple compared to 31 for the industry. It's also worth noting that estimates for the current quarter (ending December) have been steadily improving. Earnings estimates have moved from as little as \$0.08/share a year ago to \$0.14/share a month ago to \$0.16/share at present.



- Subscribers can't have helped but notice our model's predilection for overseas telecommunication companies. In previous months we have had a number of European telcos in the portfolio and last month we added one from a different continent. Telecom Argentina (TEO) is a wireline and wireless telephone service provider (revenue is divided roughly 50/50) in Argentina. The investment analyst community is split on whether this is a stock to own, with some analysts worried about government tariffs and increased competition while others focus on strong growth in wireless and DSL service. The company has a great deal of cash, but also considerable debt; since we last wrote about TEO the firm has restructured its debt more favorably than expected but is still saddled with quite restrictive covenants. TEO will benefit if greater penetration of high-speed internet access in Argentina continues apace.



- In addition to adding VLO, we are keeping shares in Tesoro (TSO), another petroleum refiner. Even though shares climbed last month, it is still valued at the

very low end of the refiner spectrum, in part because its shares have risen “only” 80% this year while the refiner index is up over 100%. 2006 estimates put TSO’s forward PE at 6.6, rock bottom among refiners. Like any energy-related business, TSO’s results are somewhat tied to the price of oil, but crack-spreads (the profit TSO makes on unrefined input v. refined output) show little sign of narrowing. Unless there is a big drop in consumption/demand, the company ought to enjoy a sustained period of higher profits. Some analysts are less enthusiastic about TSO in the near term because little of its output is channeled to heating oil, but that could turn out to be a blessing if this winter is warmer than anticipated.



- At first glance, TXU Corp. (TXU) does not look cheap. As a regulated utility (with some unregulated business in the mix) TXU could be expected to trade at moderate multiples. And it does if we look ahead to next year, but if we use current numbers, the stock would have to be considered pricey. The price-to-cash flow multiple is considerably higher than it is for the industry. The trailing 12 month PE is 28 when the typical utility trades at 16 X. But the picture changes when next year’s projections come into view; TXU shares sell for only 10 X 2006 earnings but the average among utilities is over 14. The conventional wisdom is that utilities are less than stellar performers when U.S. treasury rates are rising, since the dividend yield begins to suffer by comparison. But while TXU does pay a small dividend, investors are more likely to buy shares because of hoped-for price appreciation. Earnings are slated to rise 50% next year while the average utility is likely to see 14% earnings gains. The biggest downside is TXU’s higher-than-average exposure to natural gas prices, but much of that risk has been hedged.



- US Gypsum (USG) stays in the portfolio again this month. Subscribers may recall that we held it in August/September and achieved a nice return. Now shares have fallen back almost to what we paid for them and our model once again sees value. USG carries the baggage of litigation, namely, asbestos litigation. This is a topic of considerable debate in Congress, where legislators are trying to work out a blanket settlement for all asbestos claims. USG makes building materials and has some outstanding asbestos claims that put the company in Chapter 11. Owning this stock is a calculated risk that the company will be able to put those matters behind it and survive. There is very little analyst coverage but the single estimate for next year is for earnings of \$9.82/share, up from \$9 when we last wrote about it and giving USG a forward PE of 5. There are not any direct competitors for which there are comparable estimates, but in the classification of general building materials USG has just about the lowest earnings valuation in the market.



The table below summarizes all of the above holdings and reflects an equally weighted portfolio with \$1,000 invested in each stock using Thursday's closing prices. Stocks in **bold** letters are new positions.

December Portfolio			
Company Name	Symbol	Price	# of Shares
Aegon NV	AEG	\$16.42	61
CompuCredit	CCRT	\$39.39	25
Ford. Can. Coal Trust	FDG	\$39.25	25
Goodyear Tire	GT	\$17.75	56
Meritage Homes	MTH	\$69.45	14
Mechel Open Stock	MTL	\$24.90	40
PowerWave Tech.	PWAV	\$13.30	75
Companhia Rio Doce	RIO	\$41.23	24
Real Networks	RNWK	\$8.22	122
Silicon Precisionware	SPIL	\$5.94	168
Telecom Argentina	TEO	\$12.79	78
Tesoro	TSO	\$58.06	17
TXU Corp.	TXU	\$53.63	19
U.S. Gypsum	USG	\$62.05	16
Valero	VLO	\$106.88	9

The *ValuEngine View* newsletter is the product of a sophisticated stock valuation model that was first developed by Yale Professor of Finance Zhiwu Chen and his coauthors. It utilizes a three factor approach: fundamental variables such as a company's trailing 12-month Earnings-Per-Share (EPS); analyst consensus estimate of the company's future 12-month EPS; and the 30-year Treasury yield. These elements are all combined to create a more accurate reflection of a company's fair value than is typically available. A total of eleven additional firm specific variables are also used.

The *ValuEngine View* portfolio is constructed by integrating this model along with some basic rules for market capitalization and industry diversification. The portfolio has 15 stocks and is balanced once each month. Note that the newsletter is published in the middle of each calendar month. An equal amount of capital is allocated to each stock. The monthly returns are calculated from the closing prices on date of publication. The performance calculation does not include any transaction costs.

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