Follow the Money… please

Let me explain that catchy title. Whether it is a growth stock which is generating a powerful net cash flow (while posting a low debt to working capital ratio) or a blue chip stock company which is "thick" in their cash generation and paying out a handsome cash dividend, the one common denominator for successful stock picking boils down to **cash flow momentum. Like positive inertia, which sounds more synonymous with a physics term, cash flow momentum is a telling and dynamic economic indicator.**

Corporate America is unfortunately littered with companies that grew too fast and couldn't manage that growth… they burn out, go in to a sleepy hibernation, or just act dull in terms of valuation… always seeming to drag and underperform the averages. Corporate America is also hampered by companies that are anchored down or stalled… stagnant, not growing very much, inconsistent, debt-ridden and dealing with fading sales and revenue. And, there is another potential pitfall. The trouble with just looking at profits alone is that the real results get muddied and distorted by accounting rules, noncash charges, intangible resources and expenses (i.e. like natural resources on the books, future booked business/sales, or intellectual property), and changes in tax treatment (i.e. accelerated depreciation write-offs, options and executive company awards, lopsided R and D expenses, reserves for losses, liability, and pension shortfalls) and the list goes on and on. **So, earnings get "played with", "show-cased", and manipulated pure and simple**.

Let me show you how my research runs a reality check on the quality of profits. This knowledge will keep your portfolio healthy and wise. To separate the "rich cream from ordinary milk" (as they say), an astute screening approach is to look at something called "**free cash flow**". Simply put and without going in to the involved math, free cash flow is the money left over for the company's owners (shareholders) after paying all the bills and reinvesting in the business. When you divide the free cash number by the company's total market value (capitalization) you are now calculating the company's net-net, cash flow yield (not to be confused with dividend yield). Cash flow yields in excess of 5% qualify as strong cash flow generators and make the first cut (thereby representing sound intrinsic value). If the company is too cyclical or too erratic to generate consistently good numbers (i.e. Alcoa, International Paper, DuPont) for four quarters in a row, you won't make the 2nd cut. In fact, in year-over-year and same quarter comparisons if your actual cash flow momentum flattens (5,4,5,4,5) or decreases (6,5,4,2) this is identified as neutral and negative momentum respectively and is a reason for elimination from the list… of note, companies like Microsoft, IBM, Intel, and Dell characterized this phenomenon between 3/2001 and late 2004 despite their beautiful balance sheets.

You can further strengthen your "cash flow" favorites by examining other influential data like insider buying, favorable put/call ratios, solid financial strength ratings, and bullish buy/sell trends… now you see the "cream of the crop" stocks rise to the surface… and then P/E and PEG's really mean something.

Here is a partial list of **free cash flow favorites** with one asterik (*) denoting a high degree of cyclicality and two asterisks (**) indicating an interest-rate sensitive characteristic, while three (***) indicates a high dividend yield for its peer sector.

Conoco Phillips (COP)
Chevron Texaco (CVX)
BPT (Brit Petro-Prudhoe Bay)***
Valero Oil (VLO)
Magellen Midstream (MMP)***
Exxon Mobil (XOM)
Marathon Oil (MRO)
Schlumberger (SLB)
3M Corporation (MMM)
Toyota Motors (TM)*
Frontline (FRO)***
General Electric (GE)
Suncor (SU)***
Rohm and Hass (ROH)*
Allied Capital (ALD)**/***
American Capital Strategies (ACAS) **/***
United Parcel Services (UPS)
Illinois Tool Works (ITW)***
Clorox (CLW)*
United Health Group (UNH)

Genentech (DNA)
Amgen (AMGN)
DaVita (DVA)
Florida Power and Light (FPL)***
Proctor and Gamble (PG)
Coach (COH)*
Gap (GPS)*
Dana Corp (DCN)
Temple Inland (TIN)*
Georgia Pacific (GP)*
Weyerhauser (WY)*
Norfolk Southern (NSC)*
Allstate Insurance (ALL)**
Burlington Northern (BNI)*
Advanced Micro Devices (AMD)*
Boeing (BA)*
Bank of America (BAC)**
Genworth (GNW)**
Pepsi (PEP)*
Quest Diagnostic (DGX)

This and that…

*While **Genentech** (ticker:DNA) makes drugs for everything from strokes and heart attacks to asthma and cystic fibrosis and arthritis, the greatest potential clearly lies in its cancer drugs. Most exciting is Avastin (FDA approval). Using a modest explanation, the drug works by attaching itself to a protein that helps generate blood vessels that feed medicine to only the tumors, thereby cutting off the tumor's blood supply and causing it to "die on the vine". Currently, Avastin is used in treating colorectal and lung cancers (92% success rate reported), but initial trials strongly indicate it will work for breast, liver, kidney and ovarian cancers as well. Avastin has just broken the one billion mark in sales and the future forecast, especially after global markets kick in, is astounding… $6-8 billion per year by 2006. Wow! Herceptin and Rituxan treat other cancers like lymphnomas. Their drug Lucentis treats wet age related macular deneration… PEG is 1.6% and P/E (forward is 50)… Buy on dips for powerful long term appreciation potential.

*<u>**China still has to prove it can close a deal**</u>… overtures for Maytag and Unocal have shown to be a difficult test of merger-and-acquisition (M and A) skill. An analyst friend of mine reminds me that "the Chinese have the capital and can buy all the talent they want… telling me that instead they themselves want to do the deal making and you can't learn deal making overnight or off the Internet…" Hopefully the back off behavior signals that they want to do something more friendly than hostile… and that might be better-received and be more constructive for long term relations. For now, it is better to invest in U.S. companies doing business in China and India (Corning, Clorox, Air Products, Raytheon) than to invest directly… too many variables, unknowns and risks at this point.

*<u>**The recent terrorist attacks in London and Egypt have indeed been grim reminders of past violence and senseless acts**</u>. Investors, it appears, are starting to react to terror more rationally (if that is possible) and less emotionally. The financial markets have been more adept at quickly measuring how much damage an isolated attack will have on the global economy. This jaded or desensitized reaction is good and bad and certainly has a ripple effect. The fear factor, like other bad news, creates a sell off and can then provide a buying opportunity. How trite, but true. More on Wall Street neuroeconomics in a future Newsletter.

<u>**The improving job picture is a slightly bullish sign as national unemployment dropped to 5% in June, the lowest rate since September, 2001 and well down from the June '03 jobless peak of 6.3%**</u>... U.S. industrial production rose a healthy, almost robust 0.9% in June… well ahead of expectations (utility output accounted for much of the increase)… Greenspan and the beige book continues to tell us that inflation remains in relative "check" and that oil/gas prices are the major inflation worries… wholesale prices have been flat YTD… our opinion on crude oil is that global demand for energy will be heavy this winter and the demand, even now, will overrule normal seasonal factors in the

long term… so stay “long” with these holdings. The “Energy” sector remains “in the zone”.

In closing, let me wish everyone a wonderful Summer. I am sure I will be talking to most of you over the August/September timeframe, but please feel free to call anytime with questions. I welcome hearing from you and will continue to work diligently to carry out your investment objectives for performance, safety, and income goals. With best regards.

JC
08/05

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