

MORNINGSTAR®

Market Outlook Q2 2009

March 31, 2009

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Our Outlook for the Market

Which sectors have the most room to run?

By Bill Bergman

The market looked cheap to us last quarter, and it still looks cheap.

In recent months, our analysts have tempered their near-term assumptions for revenue and profitability amid the persistent, sharp economic recession. As a result, we've been reducing more of our fair value estimates. However, stock prices fell a bit further, leading to more attractive valuations.

In our coverage universe of more than 2,000 stocks, the average star rating rose slightly from 3.7 in December 2008 to 3.8 in March 2009, while the median price to fair value ratio declined from 0.69 to 0.65.

The significant difference between current stock prices and our fair value estimates suggest we expect a market return of about 10% annually over the next three years. With an average uncertainty rating of "medium," the market as a whole is trading at a discount sufficient enough to suggest a 5-star (consider buy) rating.

	Dec 08	Mar 09
Average star rating	3.7	3.8
Market-cap-weighted star rating	4.1	4.2
Median P/FV	0.69	0.65
Arithmetic average P/FV	0.71	0.67
Average 3-year expected return	29%	30%

Breaking Down the Valuations

Some of the best values appear to be in sectors hardest-hit by the economic environment. Among the 41 industry groups covered by our 100 analysts, the price/fair value ratios for homebuilders, home improvement retailers, automakers, industrial machinery manufacturers, packaging companies, and transportation services firms are among the lowest in our coverage universe. We don't necessarily have higher uncertainty ratings in sectors with the cheapest valuations, however. For example, we see opportunity in many health-care services and medical equipment companies, too.

We see relatively less favorable valuations for companies in the precious metals, energy, utilities, and media sectors. But we think valuations for individual firms, not sector generalizations, matter most. There are values to be found within the more expensive sectors as well.

Earnings Expectations

We don't have very rosy expectations for 2009 underneath our fair value estimates. We expect only about one-fourth of the 2,000-plus firms in our coverage universe to report higher revenue growth in 2009 versus 2008, down even further from the one-third of firms that achieved higher

revenue growth in 2008 versus 2007. In turn, our projections imply a further decline in the median operating profit margin in 2009. Further down the road, we're expecting three-fourths of the companies to have higher revenue growth in 2010 than in 2009, and we project about 80% of companies to report higher operating income in 2010 than they did in 2009.

Looking at individual industries, our earnings expectations for 2009 are quite mixed. But a coherent story emerges from the bottom-up approach of our 100 analysts. We're looking for a further decline in operating income in a majority of the 28 industry sectors that are especially sensitive to overall economic conditions. But we expect a recovery in earnings in a variety of industries linked to consumer discretionary spending, including manufacturers, retailers, and service providers. We're still monitoring current conditions closely, but it looks like consumers may lead the way out. These are near-term earnings expectations, not stock valuations, and we repeat that we see some of the most attractive valuations in sectors that were hardest hit by the recession—even in sectors where we aren't expecting a rebound in earnings this year.

For more in-depth sector and industry analysis, including our current top picks in each group, please see the accompanying reports—and happy hunting!

Banks

Given the extremely challenging and uncertain macro outlook, we think investors should stick to the high ground in this space.

Basic Materials

Weak demand abounds, with some pockets of strength and a few surprising outcomes.

Business & Financial Services

Our near-term outlook for the business and financial services industries we cover is negative in any kind of absolute sense, but we think this kind of environment demonstrates the power of economic moats.

Consumer

The best investments in the consumer goods and services sector are concentrated among companies that sell necessities—i.e., traditional supermarkets and consumer packaged goods firms.

Energy

You'd think the energy industry might be numb to bad news by now, but unfortunately the bad news kept coming in the first quarter.

Health Care

Health-care reform proposals and the 2010 budget wreaked havoc across the health-care sector, while a second news wave brought word of mega-mergers. Get our take on the regulation worries and what other deals could be next.

Industrials

The near-term may be dim, but as demand eventually picks back up, we think the machinery, transportation, and materials necessary to support infrastructure projects will strongly benefit.

Media & Telecom

Last quarter we highlighted the extreme divergence between the good and the bad within the media and telecom sector, and things have only gotten worse for weaker firms over the past three months.

Tech

The technology supply chain, from chips to hard drives, has done an admirable job of taking out production capacity in the last few months. As a result, inventory destocking has run its course for now.

Utilities

Financing, demand, and fuel price concerns have besieged the utilities sector. But as credit markets stabilize and the economy recovers, we could see more-attractive opportunities emerge among some of our top merchant and regulated utilities.

Our Outlook for Bank Stocks

Bank fears reached new crescendo in the first quarter.

By Matthew Warren

Due to mounting fears about credit losses and an increasingly harsh political climate, bank stocks' valuations compressed to new lows in the first quarter of 2009. Many of the best banks traded well below book value and the majority of lesser banks came to resemble penny stocks during the quarter as investors began to price in high probabilities on the most dire potential outcomes such as nationalization or receivership across the board.

While we concede the downside risk to the economy and the potential for the administration to come under pressure from constituents to reverse the present course, key decision makers have continued to signal that there will be "no more Lehmans" and that additional equity capital is available to systemically important financial institutions should the need arise. It should be noted that trading in nonguaranteed bank bonds and preferred stocks still reflects considerable fear on this front, despite assurances to the contrary.

Valuations by Industry

With the exception of some remaining investment banks like **Morgan Stanley** MS and **Goldman Sachs** GS, most financial firms with credit risk on their balance sheet faced significant sell-offs during the first quarter, as evidenced in the accompanying chart.

Bank Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Finance	3.9	0.46	0.52	-12%	83%
International Banks	3.3	0.51	0.55	-7%	100%
Regional Banks	4.0	0.53	0.63	-16%	70%
REITs	3.6	0.63	0.78	-19%	84%
Savings & Loans	4.2	0.66	0.86	-23%	54%
Securities	3.0	0.82	0.73	12%	87%
Super Regional Banks	4.6	0.35	0.69	-49%	90%

Data as of 3-13-09.

*Market-Weighted Harmonic Mean

** Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

For banks, sliding fourth-quarter earnings, bleak forward guidance, the U.S. Treasury's announcement regarding the initiation of a round of stress tests, and tougher political winds resulting from bailout fatigue all combined to pressure industry valuations to a degree not seen since the S&L crisis. While TARP capital infusions bolstered Tier 1 capital for all recipients, more and more banks began losing money—as reported during fourth-quarter earnings season—due to a combination of rising credit losses, stepped up provisioning, additional security write-downs, and reduced fee income. In light of this nasty combination of factors, bank analysts (and equity investors more broadly) changed their focus toward tangible equity capital, which takes the first hit from higher provisioning during this portion of the credit cycle.

We conducted our own version of a stress test to assess the largest banks' potential need for additional tangible common equity given our forecast for revenue over the next two years, combined with scenarios of varying severity regarding credit losses. The big-picture result showed that **Citigroup** C likely needed additional tangible common equity in most scenarios (following our stress test, the government obliged by offering to convert some previously issued preferred capital into common), while several large banks such as **Bank of America** BAC, **State Street** STT, **PNC Financial** PNC, **Suntrust** STI, **Fifth Third** FITB, and **Keycorp** KEY may need additional equity capital at a 10% cumulative loss rate, which would imply a substantially worse economic situation than we currently face. On a more encouraging note, we think several large banks could withstand a 10% cumulative loss rate based on current capital and provisioning levels, including **JP Morgan** JPM, **Well Fargo** WFC, **Bank of New York Mellon** BK, **US Bancorp** USB, **Regions Financial** RF, and **BB&T** BBT. Given the currently steep negative trajectory of the economy and the steady increase in loan losses across most every category, it is clear that this supercharged credit cycle will stress the entire banking industry to varying degrees based on underwriting quality, geography, product mix, and a variety of other factors.

Our Top Bank and REIT Picks

Given the extremely challenging and uncertain macro outlook, viewed in the context of global deleveraging by a substantial portion of households, corporations, and financial intermediaries, our stance reflects our judgment that investors should stick to high ground in the space. Our goal has been to recommend protection of capital by investing in firms that we think have a solid chance of surviving even the worst macro outcome, rather than attempting to shoot the lights out for the highest return from the most marginal players with the shakiest balance sheets, the very entities that will rally the most at some point—at least for those that barely survive the depths of this uber credit cycle.

Top Bank and REIT Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
American Express	★★★★★	\$54.00	Wide	Very High	0.26
City National	★★★★	\$64.00	Narrow	High	0.53
Host Hotels & Resort	★★★★★	\$15.00	Narrow	Very High	0.32
US Bancorp	★★★★	\$31.00	Wide	High	0.52
Valley National Bancorp	★★★★★	\$19.00	Narrow	Medium	0.62

Data as of 3-25-09

American Express AXP

American Express is facing the worst loss cycle for credit cards since they emerged on the scene, which is only compounded by mistakes this particular firm made with outsized portfolio growth at the peak of the cycle. That said, its fee-based spend-centric model will help absorb the current pain and will continue to produce outsized earnings on the other side of this cycle.

City National CYN

City National is one of the best houses in a bad neighborhood. While California is facing a dreadful housing and employment market, we think that City National's solid underwriting and focus on affluent customers will help it pass this harrowing test, positioning the bank to survey and exploit the damage.

Host Hotels & Resorts HST

Although we expect sharp asset and rent deflation over the next few years in the hotel REIT space due to plummeting demand and excess supply, Host Hotels & Resorts HST should weather the storm much better than peers because of its stronger balance sheet and attractive property portfolio.

US Bancorp USB

US Bancorp stands very near to the highest ground in the banking space. Not only does it benefit from a solid core franchise and underwriting culture, its fee-based businesses would allow this bank to endure much more pain than most of its peers could withstand.

Valley National Bancorp VLY

Valley National Bancorp has not faced a losing quarter since its inception in 1927. We think this bank's ultraconservative underwriting standards will meet the test posed by this sharp cycle as well.

Matthew Warren does not own shares in any of the securities mentioned above.

Our Outlook for Basic Materials Stocks

Weak demand abounds, with some pockets of strength and a few surprising outcomes.

By Elizabeth Collins, CFA

The beginning of 2009 has been a period of great uncertainty for basic materials companies. The weak global economy continues to weigh on demand for commodities such as steel, aluminum, chemicals, coal, and fertilizers. During their earnings conference calls, many companies' management teams commented that activity in the first quarter was so far mirroring the weakness seen during the end of 2008. The drop in revenues, combined with fixed cost deleveraging, is hurting many firms' earnings and cash flows. Companies are continuing to respond with layoffs, reduced capital expenditure budgets, curtailed production, and now dividend cuts. Some outfits haven't made it, though, and we saw two bankruptcies from our coverage list during the first quarter: containerboard and corrugated box producer **Smurfit Stone** SSSCO and **Chemtura** CEMJQ, a chemicals company.

Steel and aluminum producers have been hit by low demand, thanks to ailing auto and construction end markets. In the U.S., steel mills continue to hold back production to prevent an inventory glut, operating with 40% to 45% capacity utilization rates during January and February, making fixed-cost absorption a challenge. Even **ArcelorMittal** MT, the world's largest steel producer, needs to work hard to fix its balance sheet, and the firm recently cut its dividend. The situation is even more dire in aluminum markets. At current aluminum prices, the industry's best assets are barely breaking even. **Alcoa** AA recently cut its dividend and announced plans to raise equity capital.

Chemicals markets are facing weak demand, too, although demand for agricultural chemicals has held up relatively well. Amid this precariousness in the first quarter, **Dow Chemical** DOW and **Rohm and Haas** ROH finally reached an agreement to close Dow's acquisition of Rohm by April 1. Dow's plans had been undermined when Kuwait Petroleum and Petrochemical Industries walked away from the joint venture that would have provided Dow with roughly \$7 billion in cash proceeds. Now that the Dow-Rohm deal is proceeding, Dow must work quickly to pay down the balance of its bridge loan.

There are many storm clouds on the horizon for coal companies. The immediate concern for producers of metallurgical coal (a raw material for steelmaking) is significant demand weakness. However, producers of thermal coal (used to generate electricity) aren't immune from economic weakness. Peabody Energy (TU, the nation's largest coal producer, expects demand for coal to fall 60 million to 70 million tons this year—caused by a combination of weak export demand, inventory drawdowns, weak gross domestic product, and cheaper natural gas replacing coal. We haven't witness a fall of this magnitude for decades.

In the fertilizer space, the effects of the global economic slowdown have manifested in a virtual standstill in global fertilizer markets that has persisted for months. As a result, despite significant capacity curtailments, inventories have piled up all the way to the producer level. In early March the **Belarusian Potash Company** BPC reduced the price it will charge

for potash for delivery to large Brazilian importers to \$750 per metric ton from a prior level of \$1,000 per metric ton. We believe this has set the stage for Canpotex (which represents **Agrium AGU**, **Potash Corp.** POT, and **Mosaic** MOS) to accept lower prices in the coming year.

While most drivers were negative during the first quarter, some forces have been pointing up, which has contributed to uncertainty and created a wide range of possible outcomes for basic materials companies in 2009. Copper prices have bounced from \$1.30 at year-end 2008 to over \$1.80 today, although they're still a far cry from the peak of over \$4.00 reached in July 2008. The partial recovery in copper prices has given producers such as **Freeport-McMoRan** FCX some much-needed breathing room. In addition, while most basic materials industries suffered from end-market weakness, there were some pockets of strength. For example, **Monsanto's** MON seed business has continued to perform well. Further, although we saw some companies with precarious financial health go bankrupt, other companies with similarly weak balance sheets were rescued by suitors or favorable refinancing. For example, **Nova Chemicals** NCX, a struggling chemicals producer with a crushing debt load, received a takeout offer from Abu Dhabi's International Petroleum Investment Company at a hefty premium.

As we progress through 2009, we'll be looking for signs that demand for commodities is stabilizing. The upcoming price negotiations between major producers and consumers of iron ore, metallurgical coal, and potash will be important signposts. Against the backdrop of this weak demand for many commodities, we're choosing to highlight three companies whose business models include the provision of value-added services in "Our Top Basic Materials Picks" section.

Valuations by Industry

Presently all of the industries in the basic materials sector appear undervalued. Coal companies are trading at the steepest discounts to their fair value estimates, followed by building materials companies and miners (nonferrous/nonmetals). However, because coal companies have higher uncertainty ratings, the building materials and mining (nonferrous/nonmetals) industries have higher average star ratings. Five-star stocks in these categories include **Vulcan Materials** VMC and **Compass Minerals** CMP, a company we highlighted in our last Quarter-End Insights piece. The engineering and construction industry seems to be the most fairly valued, and it also carries the lowest average star rating. We even have a couple of 2-star companies—i.e., slightly overvalued based on our fair value estimates—in this industry, including **Headwaters, Inc.** HW and **Layne Christensen Company** LAYN.

Basic Materials Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Building Materials	3.90	0.57	0.62	9	65.4
Chemicals	3.80	0.81	0.66	-19	55.9
Coal	3.70	0.56	0.55	-2	74.8
Engineering & Construction	3.20	0.80	0.91	14	57.5
Forestry/Wood	3.80	0.64	0.76	19	39.4
Gold & Silver	3.40	0.63	0.60	-5	71.7
Metal Products	3.90	0.62	0.62	0	72.4
Mining (Nonferrous/Nonmetals)	3.90	0.59	0.52	-12	46.5
Paper	3.70	0.62	0.67	8	69.3
Steel/Iron	3.60	0.64	0.62	3	75.6

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Our Top Basic Materials Picks

We've picked five stocks from our 4- and 5-star lists to keep on your radar screen. Three of these companies provide valuable services in addition to products: **Ecolab** ECL helps institutions and companies with their cleaning and sanitizing needs, **Nalco** NLC administers water treatment services, and **Sigma-Aldrich** SIAL helps researchers find the chemicals they need. We're also highlighting **Cameco** CCJ, the world's largest uranium miner. Finally, **Martin Marietta** MLM is a leading producer of aggregates (sand, gravel, and stone) for the construction industry. While a good chunk of its business is exposed to the ongoing slowdown in residential and nonresidential construction, this could be partially offset by stimulus package spending on roads, bridges, and railways.

Top Basic Materials Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Cameco Corporation	★★★★	\$25.00	None	High	\$12.50
Ecolab, Inc.	★★★★★	\$47.00	Narrow	Low	\$37.60
Martin Marietta Materials	★★★★	\$105.00	Wide	Medium	\$73.50
Nalco Holding Company	★★★★	\$23.00	Narrow	High	\$11.50
Sigma-Aldrich Corporation	★★★★★	\$55.00	Narrow	Medium	\$38.50

Data as of 03-20-09.

Cameco Corporation CCJ

Cameco is the world's largest uranium miner, boasting high-grade reserves and low-cost operations. Renewed global interest in nuclear energy as a clean and reliable source of power should position the firm for growth and continued profitability. We think the mismatch between global uranium demand and production will ensure that these profits are rather large. Global uranium consumption has risen steadily during the past few decades. Because of an extended period of low uranium prices that provided miners little incentive for exploration and development efforts, global mine output failed to follow suit, producing a shortfall that persists to this day. Various secondary sources have filled the gap, including decades-old inventories

held by utilities and governments, as well as down-blended uranium sourced from dismantled warheads. As secondary sources dwindle, we think sustained high prices will be necessary in order to get mine investments to close the gap between consumption and production.

Ecolab, Inc. ECL

Ecolab produces and sells cleaning products and services to institutional, hospitality, and industrial customers. Its offerings include textile and ware washing systems, detergent, and vehicle-care and pest-elimination products. Ecolab's major customers are restaurants, hotels, hospitals, food and beverage plants, and schools. It aims to become a one-stop shop for its clients' cleaning and sanitizing needs. To this effect, the company has made substantial strides toward increasing sales and improving operating performance in its kitchen equipment repair service and expanding its presence in the health-care market. Although the hospitality and food service industries are facing softer demand from consumers, Ecolab should be able to make up for some slower revenue growth by gaining additional market share.

Martin Marietta Materials MLM

Martin Marietta Materials is a leading producer of aggregates for the construction industry. We think Martin has a sustainable competitive advantage, thanks to its collection of quarry assets across North America, which is complemented by its land- and water-based distribution network. We believe Martin's quarries will be an increasingly valuable asset, as we expect aggregate supply growth to be constrained by regulatory challenges for opening new quarries and high transportation costs for competitors with quarries in more-remote areas. These factors, combined with recent consolidation by large aggregate companies such as Martin, should support better-than-inflation pricing in the medium and long term.

Nalco Holding Company NLC

Nalco provides integrated water treatment and process improvement services, as well as chemicals and equipment programs for industrial and institutional applications. These can include anticorrosion techniques, papermaking process improvements, and upstream and downstream energy services. Nalco has been able to establish itself as the premier name in the water treatment market by offering a combination of innovative products and high-touch service that is unmatched by its competitors. Nalco owes much of its success to its service-driven business model. The company stations engineers at many of its clients' sites, where they are able to leverage their knowledge of their customers' assets to meet their ongoing water treatment needs and capitalize on opportunities to cross-sell other Nalco solutions.

Sigma-Aldrich Corporation SIAL

Sigma-Aldrich is a leading producer and supplier of research biochemicals, organic chemicals, and fine chemicals. Sigma's products are sold to universities, government institutions, and biotechnology and pharmaceutical companies, as well as other industrial and high-tech firms. The firm has been able to distinguish itself in the crowded chemical market by stocking an enormous array of compounds and focusing on creating a superior distribution network. Unlike many of the chemical companies in our coverage universe, Sigma receives a narrow

economic moat rating, which stems from the company's pricing power and customer loyalty. Sigma largely sells consumable products necessary for the research process, and its customers typically spend only 5% of their budgets on these items. This combination of necessity and the relatively small price tag of these items makes demand highly inelastic and allows Sigma to consistently pass on price increases as its internal cost structure changes. In addition, Sigma has a high customer retention rate, in part because of its best-in-class Web site.

Elizabeth Collins, CFA, has a position in the following securities mentioned above: CCJ

Our Outlook for Business and Financial Services Stocks

Companies with moats and strong balance sheets should outperform.

By Brett Horn

2008 was unkind, and 2009 doesn't look to be any nicer. Our near-term outlook for the business and financial services industries we cover is negative in any kind of absolute sense, but we think this kind of environment demonstrates the power of economic moats. We also believe that financial leverage is poison during a downturn. Our opinion is that companies with strong competitive advantages and balance sheets will outperform and reward the patient investor. Looking at a range of seemingly disconnected industries demonstrates the point.

Take the staffing industry, for instance. The employment market has reached a depressed state not seen since the early 1980s. The unemployment rate has increased to 8.1% and the U.S. has lost 4.3 million jobs. The temporary employment segment, a leading indicator of the overall employment market, has seen job losses accelerate month after month, with February 2009 being the worst yet. We don't expect this trend to reverse anytime soon, meaning there's more stress ahead for the staffing industry. But not all employment-related firms are as sensitive to the overall employment market, and our picks have substantial competitive advantages that insulate them from the down cycle. We believe **Paychex** PAYX and **Automatic Data Processing** ADP are attractively priced given their strong competitive position. Scale, high customer switching costs, and a respected brand image constitute a triumvirate of advantages and the companies' debt-free balance sheets mute near-term risk.

Waste management is an industry we like better than staffing, but it also faces a tough near term. In November, recycling commodity prices fell through the floor as China—the largest buyer of plastics and old corrugated cardboard—halted demand. As demand for commodities plummeted, commodity prices of recycled goods dropped from \$130 per ton to \$20 per ton, on average. In addition, waste volumes continued to decline due to slowing demand for construction and demolition. We believe the industry will continue to offset lower waste volumes with rational price hikes, which should minimize the operating margin impact. But given the capital intensity of this industry and the resulting financial leverage, there's not a lot of room for error. With ongoing uncertainty surrounding the economy and ultimately waste volumes, we think that investors are best advised to look to the companies that have the strongest competitive advantages and use leverage only moderately. In our opinion, **Waste Management** WMI and **Waste Connections** WCN are most worthy of keeping on your radar.

Turning to the financials side, insurance companies continue to struggle due to their exposure to capital market conditions, and they are doubly cursed due to their balance sheet leverage to the large investment portfolios they carry. With equity markets cliff-diving and credit spreads blowing out, almost all asset classes are taking a hit. While stocks in the insurance industry have taken a pounding, we are maintaining our cautious stance. In this environment, we think the proportion of book equity to the investment portfolio is a key statistic, and, for the most part, we are limiting our recommendations to insurance companies that are positive outliers in terms of capital strength, such as **Mercury** MCY.

The asset managers are also exposed to capital market declines, and their operating results in 2009 will show a dramatic decline from 2008 levels, barring a miraculous market recovery. Although their near-term fortunes will wax and wane with the direction of the market (something we are loath to predict), we think the players with a diversified lineup of investment offerings and customer bases, intact reputations, and the cleanest balance sheets will not only outperform over time, but will also seize upon this period of stress to further expand their presence. From this point of view, we think **BlackRock** BLK is the best positioned.

Valuations by Industry

In the table, it can be seen that, while our price/fair value estimate ratios don't vary wildly by industry, our uncertainty about those fair value estimates do differ quite a bit.

Business and Financial Services Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Business Support	4.09	0.66	0.61	8%	39%
Business/Online Services	3.87	0.66	0.58	14%	67%
Consultants	3.48	0.73	0.76	-4%	43%
Data Processing	4.46	0.58	0.62	-6%	43%
Education	4.31	0.72	0.81	-11%	37%
Employment	3.73	0.62	0.70	-11%	95%
Insurance (Property & Casualty)	4.13	0.60	0.79	-24%	82%
Insurance (Life)	3.06	0.81	0.95	-15%	81%
Insurance (Title)	3.38	0.63	0.74	-15%	88%
Money Management	3.75	0.69	0.72	-4%	58%
Personal Services	4.91	0.63	0.75	-16%	21%
Reinsurance	3.54	0.63	0.81	-22%	92%
Waste Management	3.94	0.70	0.76	-8%	54%

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Data processors carry one of our highest average star ratings and there's a lot to like about this type of business in the current environment. Their asset-light business models create very limited (or no) financing needs, which tends to lead to little debt on the balance sheet. Additionally, in general, their businesses tend not to be very cyclical and produce stable free cash flow, a valuable characteristic in tough times.

We think insurance companies are generally undervalued, but we also think that a high margin of safety is required, due to the industry's exposure to volatile credit markets. As a result, we don't have a lot of recommendations in this space. On a relative basis, we like reinsurance and property & casualty insurance better than life insurance, as these companies have larger equity cushions to absorb investment losses.

Although we believe that asset management is an extremely attractive business from a long-term perspective, the market plunge has hit these companies hard and much of that is being reflected in their valuations. The emphasis for investors here is that market declines have a very real impact on these businesses, and these stocks will continue to be volatile as long as the markets are unsteady.

Our Top Business and Financial Services Picks

Top Business and Financial Services Sector Picks					
	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Automatic Data Processing	★★★★★	\$58	Wide	Medium	15.9
Mercury General	★★★★★	\$53	Narrow	Medium	N/A
Jack Henry	★★★★★	\$24	Wide	Medium	14.1

Data as of 03-18-09.

Automatic Data Processing ADP

We think ADP can withstand the strongest of labor market head winds. Even if the employment market takes a dramatic turn further downward, businesses still need to pay their existing employees. The high customer switching costs and business model scalability for ADP should help the firm preserve revenue and profits. The minimal amount of capital required for its operations adds greatly to the attractiveness of this firm. Stable and robust cash flow has enabled ADP to keep its debt balance at zero and the substantial strength of its balance sheet is reflected by a AAA credit rating. ADP has consistently produced strong operating margins and great returns on invested capital over an extended period of time and we believe this trend will continue.

Mercury General MCY

Like most insurers in 2008, Mercury fell victim to higher yield spreads in its investment portfolio, but unlike most insurers, Mercury has the benefit of a relatively strong capital position. Its debt/equity ratio of 10.5% is low—and its conservative strategy of allocating most of its investments to tax-exempt government bonds reduces risk. More importantly, Mercury has a fat equity cushion to absorb investment losses, as book equity covers 50% of its portfolio holdings, a considerable amount of downside protection. Mercury also has a winning sales strategy of focusing on low-cost auto insurance, which is nicely attuned to today's economy, and Mercury's solid distribution channels and wide sales reach position it to grow market share. Judging by its disciplined underwriting, which has allowed Mercury to earn superior profit margins averaging 6% over 15 years, we think the company's prospects are good.

Jack Henry JKHY

Jack Henry is one of the top core processing providers for domestic financial institutions, and it also offers related services and products like risk management and online banking software. Because a bank's operations depend on core processing (which control day-to-day operations), the cost of switching providers is prohibitive, allowing the industry to avoid profit-killing competition. The high switching costs for its customers lead to multiyear contracts and 99%

renewal rates, excluding acquisitions of customers, providing a base of recurring revenues for Jack Henry, even in the face of a struggling financial services industry. While discretionary purchases by its customers will likely fall as banks conserve capital, the steady core processing revenues will help insulate Jack Henry from the effects of the banking crisis. With no long-term debt, solid cash flows, and little need for reinvestment, Jack Henry's financial position is as solid as they come.

Brett Horn does not own shares in any of the securities mentioned above.

Our Outlook for Consumer Stocks

A shift from nondiscretionary spending is weighing on the consumer sector.

By Joseph Beaulieu

Consumer spending continued to suffer as the U.S. economy struggled through yet another quarter of recession. While employment numbers were certainly bad, they were not bad enough in themselves to account for the striking slowdown in discretionary spending. Factors contributing to consumers' unwillingness to crack open their wallets include: unending talk from the political class and the punditry about a possible depression (or merely the worst economy since the 1930s), a massive decline in wealth from home and stock portfolio values, and fears about tax increases and inflation driven by budget policy.

Consumers' fears are impacting spending in two ways: dramatic declines in discretionary spending and a shift of nondiscretionary spending to less-expensive channels and to private-label products.

The slowdown in consumer spending is having a profound impact on the gaming industry, particularly in Las Vegas. In the face of uncertain job prospects, plummeting home values, and decimated investment accounts, people are cutting back on trips to casinos, and those who are still going are gambling less. According to the Las Vegas Convention and Visitors Authority, in January visitor volume and gaming revenue in Vegas were down 11.9% and 16.3%, respectively, compared with January 2008. In light of these sharply lower visitation levels, the gaming firms are taking aggressive steps to keep their hotels from emptying out. Room rates are being slashed, and incentives like free meals and slot play are on the rise. These initiatives may keep occupancy levels from dropping off a cliff, but they are bringing down margins and hurting cash flows. Smaller regional casinos, which are a quick drive away from core patrons, are performing somewhat better in this environment but are still feeling the impact of cash-strapped consumers. Our expectation is that the gaming industry will continue to show weakness in the coming quarters, as consumers show no signs of being ready to open up their wallets on the casino floor.

Retailers have also continued to take it on the chin through the first few months of the year. Monthly same-store sales have been mostly negative across most of our coverage universe. Most of the firms we cover have reported declines of both traffic and average ticket. However, three notable exceptions were **Wal-Mart** WMT, **Costco** COST, and teen-retailer **Aeropostale** ARO, all of which offer compelling value propositions. Unsurprisingly, broad categories such as dollar stores (**Dollar Tree** DLTR, **99 Cents Only Stores** NDN, and **Family Dollar Stores** FDO), auto parts retailers (**O'Reilly Auto Parts** ORLY, **AutoZone** AZO, and **Advance Auto Parts** AAP), and off-price retailers (**Ross Stores** ROST and **TJX** TJX) saw their sales hold up well.

On the other hand, anything smacking of luxury, including high-end department stores (**Nordstrom** JWN and **Saks** SKS), specialty retailers selling jewelry and accessories (**Tiffany** TIF and **Coach** COH), and most apparel suffered. We think these firms will continue to face massive head winds throughout the rest of the year.

Within the consumer goods sector, companies selling necessities such as food, household products, and personal care products saw their sales hold up relatively well. Retailers such as Wal-Mart, **Target** TGT, and **Walgreen** WAG, all of which sell a mix of discretionary and nondiscretionary goods, reported a marked shift away from nondiscretionary purchases.

Many consumer packaged goods firms, grocers, and even restaurants held up well. **Kroger** KR reaped the benefits of offering a great value proposition in the traditional grocery store market, and although **Safeway** SWY didn't fare as well, it still posted growth. Purveyors of "basic" grocery items such as **Campbell Soup** CPB and **General Mills** GIS held up nicely as consumers sought out bargains and ate more meals in their homes. For consumers dining out, **McDonalds** MCD has continued to post strong results, and value-oriented casual restaurant chains from **Darden** DRI showed some resiliency.

Valuations by Industry

In our opinion, the best investments in the consumer goods and services sector are concentrated among companies that sell necessities—i.e., traditional supermarkets and consumer packaged goods firms.

Consumer Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Alcoholic Drinks	3.84	0.73	0.78	-7%	44
Apparel Makers	3.96	0.61	0.64	-6%	59
Appliance/Furniture	4.01	0.50	0.77	-35%	95
Beverage Manufacturing	4.80	0.69	0.73	-5%	2
Clothing Stores	4.00	0.57	0.55	3%	74
Dept Stores	4.60	0.48	0.49	-3%	77
Discount Stores	4.05	0.74	0.85	-12%	2
Food Manufacturing	4.76	0.66	0.73	-10%	5
Gambling/Hotel Casinos	3.19	0.78	0.86	-9%	80
Groceries	4.70	0.61	0.70	-13%	22
Hotels	3.27	0.73	0.73	0	89
Household/Personal Prod	4.89	0.62	0.75	-17%	1
Restaurants	4.10	0.72	0.77	-6%	3
Specialty Retail	4.71	0.65	0.71	-9%	30
Tobacco	4.54	0.64	0.70	-8%	28

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Because of the macroeconomic factors we discuss above, most of the industries within the consumer goods and services sector look cheap. But given the possibility of yet another unexpected macroeconomic event (inflation? trade war? bank run?), we think that investors should be focused on some of the less-discretionary industries within those sectors.

Our Top Consumer Picks

In assembling our top picks for this quarter, we have remained focused on firms that manufacture or sell primarily nondiscretionary goods. Notable absences from our picks list include dollar stores, off-price apparel retailers, and the two big discount retail chains. Most of the firms in these categories are already fairly valued, and the one that is substantially undervalued (Target) faces risks related to its credit card portfolio and the potential of a contentious proxy battle with its largest investor, who wants the firm to spin off its real estate to a REIT—a risky proposition, in our opinion.

Top Consumer Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
General Mills	★★★★★	\$70	Narrow	Low	0.70
Procter & Gamble	★★★★★	\$77	Wide	Low	0.63
Molson Coors	★★★★★	\$59	Narrow	Medium	0.60
Safeway	★★★★★	\$33	None	Medium	0.56
Walgreen	★★★★★	\$38	Narrow	Medium	0.70

Data as of 03-26-09.

General Mills GIS

We like General Mills at its current valuation. We think that the nondiscretionary nature of its products, the potential for increased international expansion, new product launches, and the firm's proven ability to raise prices make the firm attractive even in a recession.

Procter & Gamble PG

Although both Procter & Gamble and Colgate Palmolive CL look attractive at current levels, we are choosing P&G because we think it is cheaper, and we think that the firm's pre-downturn efficiency push is likely to show some benefits, even in a tough environment.

Molson Coors TAP

We like Molson Coors because beer is typically a resilient category in a recession, and we see the potential for some margin improvements that the market isn't yet anticipating.

Safeway SWY

It was a difficult call deciding between Kroger and Safeway, as both stand to benefit as consumers go "back to basics." Safeway is more of a bargain at current valuations, so we decided to go with that as one of our picks. However, investors more concerned about the consistency of results might pick Kroger instead.

Walgreen WAG

Finally, recent results at Walgreen suggests that the company's turnaround efforts are showing some benefits, and while the firm's mix of nondiscretionary items and increasing competition in the prescription drug market add some risks, we think that the stock still looks cheap.

Joseph Beaulieu does not own shares in any of the securities mentioned above.

Our Outlook for Energy Stocks

Presidential budget concerns add to the industry's present woes.

By Eric Chenoweth, CFA

You'd think the energy industry might be numb to bad news by now, after absorbing both a collapse in oil and natural gas prices and a credit crisis of historic magnitude. Last quarter, we wrote about how the carnage had spread from equity and debt markets to companies' budgets. Unfortunately the bad news kept coming, as the president's recently proposed budget places the U.S. energy industry in its crosshairs, attempting to squeeze what little blood remains in the stone today. Additionally, we hear rumblings of greater regulation in the background, the most important of which concerns clamping down on hydraulic fracturing, thus taking aim at the speedy, economic development of one of the final frontiers of natural gas drilling in the U.S.—shale gas.

The budget and regulatory rumblings add a new wrinkle for energy investors. Before this news, there was a clear upside to the credit crisis, oil and gas price collapse, and capital spending reductions—future supplies would be curtailed, sowing the seeds for higher oil and gas prices someday. This budget and regulatory news clearly adds to the ability of the already existing shakeout to force weaker producers out of business and curtail oilfield activity, thus further strengthening the case for higher natural gas and oil prices in the future. However, it also reduces the ability of healthy U.S. energy firms (the survivors) to thrive in a higher-priced environment. Burdened with new taxes and regulations that would retard investment and development of some of the industry's brightest growth prospects, U.S. oil and gas producers may not be able to transform the higher oil and gas prices into meaningful profit expansion, as they could during the last boom.

We've written about the M&A environment for oil and gas prices recently, as our outlook is for more activity at lower prices this year. Many of the weaker players are facing reduced borrowing capacity and some may be overdrawn, pushing them to look to asset sales to improve their liquidity. Uncertainty stemming from the budget proposal is likely to further negatively impact the U.S. M&A marketplace, as bidders face greater difficulty estimating future oil and gas property economics, leading many of them to lower their bids further. We view the 2009 M&A market as an opportunity for firms with financial flexibility and a sizeable hurdle for firms facing financial distress.

In the short run, we still see oil prices caught between OPEC's efforts to reduce supplies (with help from high-cost producers in non-OPEC countries shutting down operations, too) and very weak demand. However, since our last quarterly outlook, we have grown more impressed with OPEC's ability to curtail output. Further, we expect incremental reductions in demand are shrinking and the potential for demand to stabilize and potentially start to creep upward is becoming more likely than it was a quarter ago. Oil inventories remain very high, however, and spikes in the oil price are likely to be met with waves of oil flowing out of storage. Over the

longer term, once inventories slim down and demand strengthens, we expect higher oil prices. North American natural gas prices failed to gain support from winter weather as it was offset by incredibly weak industrial demand, so inventories look primed to be higher than average in 2009. We expect natural gas supply will remain strong in the first half of 2009, as sizeable levels of investment committed in 2008 flow through the system, supporting weaker prices in the short run. However, we expect domestic output to begin declining in the second half of 2009 as the dramatic reduction in the natural gas rig count starts to manifest itself. This supply view supports a rebound in gas prices beginning sometime in the second half of 2009 and gaining steam in 2010. One wild card still exists—LNG shipments—and it could extend the weak natural gas pricing environment a few quarters. LNG cargoes were few and far between in 2008, as strong Asian demand kept cargoes from drifting west. With Asian economies weakening there is a different story emerging in 2009, as we see cargoes shifting westward to Europe and the U.S. So we expect significant growth in LNG imports to the U.S. versus 2008, but the ultimate magnitude remains unclear and we're watching it closely.

One of the offshoots of lower natural gas drilling activity in the U.S. is reduced capacity utilization in the drilling rig and services market. We think this overcapacity could persist for a number of years, especially if the proposed budget and stricter regulation prevail. We reduced our long-term natural gas price assumption in February as the potential for lower well costs became more clear to us. Further, in light of the budget proposal, we increased our uncertainty ratings for U.S.-focused oil and natural gas producers in March.

Valuations by Industry

Presently all of the subsectors in the energy sector appear undervalued. Pipelines are trading at the steepest discount to their fair value estimates, followed by drillers and service firms (oil and gas services). It's important to note that drillers and service firms rated similarly compared with refiners (oil and gas products) when considering average star rating. This is because of the higher uncertainty ratings that drillers and service firms receive—as shown by looking at the high uncertainty percentile. Pipelines, E&Ps, and major integrated firms (oil & gas) garner our highest average star ratings and offer the best and most abundant selection of investment ideas in the energy sector.

Energy Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Oil & Gas	3.90	0.71	0.72	-1	41.7
Oil & Gas Services	3.60	0.74	0.59	25	83.5
Oil & Gas Products	3.60	0.68	0.61	11	90.6
Pipelines	4.30	0.58	0.61	-5	7.9

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Our Top Energy Picks

We've picked five stocks from our 4- and 5-star list to keep on your radar. Two of our picks, **Chevron** CVX and **ExxonMobil** XOM are large, integrated oil majors that are well-positioned companies for a turbulent operating and financing climate like we face today. Two picks are pipeline companies, **Energy Transfer Equity** ETE and **Spectra Energy** SE. We've been especially impressed with the way Energy Transfer has assembled a great set of midstream assets within Texas, the Midcontinent and the Southwest—a position that adds a lot of value to its E&P customers in the region and one with a lot of potential for healthy growth. Spectra also possesses an attractive set of long-haul natural gas pipelines that connect high-demand regions in the Northeast with supply centers in Texas and the Gulf Coast. **Canadian Natural Resources** CNQ is a Canadian-focused E&P determined to drive costs down within its operations. It could benefit if its U.S. competitors are forced to curtail drilling activity due to new taxes and greater regulation.

Top Energy Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Consider Buying
Exxon Mobil	★★★★★	\$87	Wide	Low	\$69.6
Chevron	★★★★★	\$91	Narrow	Medium	\$63.7
Energy Transfer Equity	★★★★★	\$51	Narrow	High	\$25.5
Spectra Energy	★★★★★	\$25	Wide	Medium	\$17.5
Canadian Natural Resources	★★★★★	\$77	Narrow	High	\$38.5

Data as of 03-18-09.

Energy Transfer Equity ETE

We're big fans of **Energy Transfer Partners** ETP and we think that its general partner, Energy Transfer Equity, presents an attractive opportunity for investors who are interested in natural gas pipeline plays and are looking more for growth than yield. We think unitholders of ETP will see distributions increase at an 8% average annual rate during the next decade, and because of the general partner MLP structure, ETE should be able to boost its distributions at nearly twice that rate. In the past year Energy Transfer has demonstrated an ability to grow through partnerships, with joint ventures such as the Midcontinent Express Pipeline and Fayetteville Express Pipeline, both partnerships with **Kinder Morgan** KMP. Also, we note that ETE's current yield is similar to ETP's, which makes little sense given that incentive distribution rights give ETE an increasing claim on ETP's growing cash flows. We think investors stand to see greater unit price appreciation from ETE than from ETP, and in the meantime, they can collect a similar yield on a distribution that will increase more rapidly than ETP's.

Canadian Natural Resources CNQ

Canadian Natural Resources has a cost-conscious approach to value creation. In addition to long-term investments that will result in significant production gains, the company has shown a knack for making complementary acquisitions at reasonable prices. If it can continue to effectively manage its capital costs, this dominant Canadian energy player should experience years of outsized returns.

Exxon Mobil XOM

Although we believe several buying opportunities exist in the major integrated space, Exxon is our first choice for a turbulent market environment. Exxon's returns on capital regularly exceed its peers'. Its ability to choose from among some of the best mega-projects around the globe helps it drive these higher returns. Its track record of delivering projects on time and under budget makes it a preferred partner on mega-projects. Exxon's ability to integrate its global network of oil and natural gas production, transportation, refining, and chemicals manufacturing, and drive costs down throughout the system, further underpin its high returns and buffer it during weaker commodity price environments.

Spectra Energy SE

Spectra Energy operates one of the largest midstream footprints in North America, touching many of the continent's most prolific producing areas. Stable fee-based cash flows from pipelines, storage, and distribution operations comprise roughly 80% of cash flows, largely insulating Spectra from commodity price and volume fluctuations. More specifically, customers pay Spectra reservation fees for the right to use a specified amount of transportation or storage capacity, regardless of actual usage. We think the stock currently trades for less than the value of these fee-based cash flows alone. The remaining 20% of cash flows, which stem from commodity-sensitive gathering and processing operations, offer free upside potential whenever commodity prices rebound, in our view.

Chevron CVX

Chevron's position as the second-largest oil company in the U.S. gives it the resources to explore for and produce hydrocarbons throughout the world. The majority of its portfolio of projects is located outside the United States and involves partnerships with national oil companies. Chevron presents itself as an expert in exploration and production, which makes it attractive to governments looking to capitalize on their resource base. Ongoing offshore drilling and natural gas infrastructure projects that require heavy investment are often out of the reach of smaller competitors, though they are readily available to Chevron. Chevron's recent investments in deep waters offshore should start to pay off through higher production volumes in upcoming years.

Eric Chenoweth, CFA has a position in the following securities mentioned above: ETE, CNQ, CVX, XOM

Our Outlook for Health-Care Stocks

Health-care reform and mega-mergers dominate the news.

By Alex Morozov, CFA

In contrast to the fourth quarter of 2008 when health-care stocks took a nose-dive along with the rest of the market, industry-specific developments were the main catalyst for the sector's largely negative performance in the first quarter of 2009. Two main themes dominated: health-care reform and the mega-merger activity in the pharmaceutical area. The news on the regulatory front carried particular significance, as the message sent by the Obama administration was clear: Health-care reform would not take a back seat to the economic crisis, and the system could undergo a significant overhaul as early as next year.

The news flow pertaining to the reform and the 2010 budget wreaked havoc across the sector. It wasn't necessarily what was explicitly stated in the budget proposal and corresponding supporting documentation, but rather the anticipation by the market of what could be forthcoming in the near future. The scant details of the Obama administration's plans that have emerged so far haven't quelled investor fears. Expectations of far-reaching proposals, such as direct price negotiations between the government and drugmakers, drug reimportation, competitive bidding, bundled payment system for hospital reimbursement, and (the bogeyman) socialized medicine, were rampant, sending shares of drugmakers and device makers, along with the rest of the health-care space, reeling.

To be fair, the 2010 budget contained a number of proposals that could directly or indirectly benefit various health-care sectors. The president's information technology proposal, for example, should meet little, if any, resistance and offers a way to reduce waste from one of the least IT-advanced sectors of the economy. One would be hard-pressed to find a reasonable argument for opposing the proposal that would computerize all the medical records in the United States over the next five years. The market took notice. Shares of Cerner Corp. CERN a health-care IT solutions provider, are up nearly 20% since the administration unveiled its plan. Investment in prevention and wellness programs could provide a boost to the diagnostic sector, although it potentially could be offset by the efforts to scale back on what could be deemed excessive patient testing. A pathway for advancement of generic biologics and efforts to restrict patent shelf of reformulated or "me-too" drugs are also to be lauded; the actual mechanisms of action on both fronts remain largely unknown, but the call for innovative technologies could be a sign that the Food and Drug Administration may be increasingly favoring drugs that address unmet needs or offer unique solutions to various ailments. Finally, President Obama is eager to deliver on his promise of expanded insurance coverage, which would add up to 46 million Americans to the insured population pool, potentially boosting enrollments for many managed care organizations (MCOs).

This potential enrollment expansion was seemingly the only positive news for the managed care industry, however. The administration has also unveiled its proposed means of paying for its health-care plan, and managed care, along with wealthy individual taxpayers, could be picking up the tab for the lion's share of the initial \$630 billion plan cost. Our managed care

analyst, Matt Coffina, in a recent article attempted to assess the impact of various proposals to alter the U.S. payer system on managed care companies we cover. Here are some key takeaways: The administration proposal pertaining to MCOs that is deemed most likely to succeed—reduction of reimbursements to Medicare Advantage plans provided by private payers—hasn't come as a surprise and has already been incorporated in our analysis. But other ideas, not explicitly in the budget but apparently deliberated by the administration, pertain to the overhaul of the entire payment provider system, and could have drastic implications on our thesis and valuation for the managed care sector.

The wave of mega-mergers in the pharmaceutical space has also made notable headlines in the first quarter. In a flurry of activity, the likes of which have not been seen since 1999–2000 when the Pfizer/Warner-Lambert, Astra/Zeneca Group, Glaxo Wellcome/SmithKline Beecham mega-deals were completed, the pharmaceutical space has undergone massive changes just over the past 90 days. **Pfizer's** PFE \$68 billion planned acquisition of **Wyeth** WYE, the shotgun marriage of Roche and **Genentech** DNA, and the just-announced deal between **Merck** MRK and **Schering-Plough** SGP have reshaped the industry environment and signaled that the consolidation wave triggered by patent expirations, earnings pressure, and regulatory uncertainty is gaining momentum. It is possible that a few other large deals could be in the making (rumors surrounding **Bristol-Myers Squibb** BMY and biotech giant **Amgen** AMGN as potential acquisition targets have been floating for quite some time), but the focus, in our opinion, is largely shifting toward smaller, more focused drug developers, such as **Biogen Idec** BIIB or **Elan** ELN.

Valuations by Industry

Not surprisingly, given the overall negative tone of regulatory news flow, shares of drug developers and hospital service providers didn't fare well in the quarter. Further, tough economic conditions continue to weigh down the industry, as rising unemployment and rapidly deteriorating consumer wealth are causing individuals to scale back on health-related expenditures.

Health-Care Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Biotechnology	3.80	0.71	0.79	-8	18.9
Diagnostics	4.90	0.65	0.73	-8	17.3
Drugs	4.80	0.59	0.68	-9	6.3
Hospitals	3.80	0.59	0.62	-3	85.0
Managed Care	4.30	0.48	0.54	-6	49.6
Medical Equipment	4.70	0.56	0.59	-3	5.5
Medical Goods & Services	4.80	0.55	0.60	-5	15.0
Physicians	3.70	0.58	0.67	-9	79.5
Research Services	4.70	0.50	0.55	-5	68.5

Data as of 3-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Hospital operators are bearing the brunt of the downturn, and the stress on this sector will likely continue throughout 2009. Cash-strapped patients are delaying care for nonemergency conditions, putting pressure on hospital admissions. With unemployment on the rise, bad-debt expense is climbing, cutting into hospital profitability. Exacerbating the problem, hospitals are losing lucrative patients who are covered by commercial insurance as job cuts pile up. Internal strategic mishaps—massive financial leverage attributed to the roll-up strategy many operators deployed in the early 2000s—are also magnifying the effect of this downturn. Despite some help from the stimulus package in the form of increased Medicaid funding, we don't see many positive catalysts on the horizon for the hospital industry.

On top of current troubles, we think regulators may attempt to squeeze hospitals in the near future. One proposal in President Obama's budget specifically targets hospitals with high readmission rates, threatening to limit Medicare reimbursement via bundling payment for initial visits and any follow-ups within 30 days. However, the decline in uninsured patients that is also part of the president's plan would mean lower bad debt and charity care for hospitals. Until more details emerge, the net effect is hard to quantify.

Shares of many drug developers also tumbled immediately following the budget release (many have recovered in the weeks since), as the president's harsh rhetoric toward branded-drug makers stoked fears of pricing control. We think there is definitely some stigma attached to manufacturers of prescription drugs, which would allow the passage of certain measures aimed to curb drug costs, such as uniform reimbursement under both Medicare and Medicaid. But more radical actions—drug reimportation primarily—would yield only limited, if any, results in our opinion, as drugmakers could potentially simply restrict drug shipments to lower-cost areas to negate the government's efforts. The safety concerns would also likely render the reimportation idea ineffective. All bets are off, however, if the U.S. government consolidates purchasing to achieve greater pricing power and the country moves closer to a single-payer system—the once-unthinkable idea that is now gaining steam. A government payer wielding unequivocal bargaining strength would do irreparable damage to the drug developers' earnings power.

Our Top Health-Care Picks

Top Health-Care Sector Picks					
	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Open
Medtronic	★★★★★	\$50	Wide	Low	0.59
Elan Corporation PLC	★★★★★	\$13	None	High	0.47
AmerisourceBergen	★★★★★	\$52	Narrow	Medium	0.62
Fresenius Medical Care	★★★★★	\$59	Narrow	Medium	0.61

Data as of 3-24-09.

Medtronic MDT

Now that the Department of Justice has settled its cases with the orthopedic companies, we expect Medtronic and other peers in the spinal device market will be within the DOJ's sights and will withstand greater scrutiny of its sales practices and physician relationships going forward. Further, Medtronic is also dealing with a slow recovery in the key implantable cardioverter defibrillator market. Although 2008 ICD sales have moved back into the mid-single-digit range after suffering declines brought on by large-scale competitive product recalls, the market is unlikely to return to the 20%–30% growth that took place as the devices were introduced in the early 2000s. However, we're not ready to completely write off the ICD market. Medtronic continues to dominate the field of three major players with approximately 50% market share. We expect the market to continue growing in the midsingle digits as ICDs are one of the few devices that have substantial clinical data to demonstrate their clear superiority on mortality compared with optimal medical therapy for certain heart disease patients. As health-care reform moves closer to using comparative effectiveness data to justify the price of certain therapies, Medtronic's ICD business should be left standing tall. Moreover, Medtronic continues to invest in emerging technologies in order to lay the groundwork for future growth. Most recently, the firm has made a series of purchases in the atrial fibrillation (both radio-frequency and cryo-ablation technology) and minimally invasive catheter-based heart valve spaces. These two therapeutic areas with considerable unmet needs could grow into a combined \$2 billion to \$3 billion market over the next five to seven years, and Medtronic is well-positioned to exert a formidable presence in each.

Elan ELN

Until late last July, Elan was riding high on Tysabri's stellar relaunch and the promise of its lead Alzheimer's disease drug candidate, bapineuzumab. However, a perfect storm of events has driven Elan's stock to lows not seen in years. New cases of the potentially deadly brain infection PML have since been discovered in a handful of multiple sclerosis patients taking Tysabri, and bapineuzumab's efficacy and safety across a broad spectrum of Alzheimer's patients in Phase II studies were disappointing in light of the market's high expectations. We think PML will become an increasingly manageable (and preventable) side effect, and that Tysabri's efficacy will continue to put it among the leading treatments in the \$8 billion (and growing) global MS market. We also see enormous potential in Elan's core Alzheimer's R&D pipeline; if any of its diverse development programs reach the market, the firm could dominate a \$5 billion global market that currently lacks any disease-slowing treatment options. Elan is also exploring strategic alternatives—such as the sale of a minority stake in its equity or the firm in its entirety—in order to continue to aggressively feed its R&D pipeline and make payments on its sizable \$1.8 billion debt balance. We think Elan is likely to either find a larger drug firm eager to establish a relationship or extend its current partnerships with Biogen Idec or Wyeth.

AmerisourceBergen ABC

AmerisourceBergen, along with other drug distributors, is relatively insulated from the economic climate, as demand for pharmaceuticals tends to hold up in any environment. Although the stocks of these companies have outperformed the general market over the past year, they were down sharply in the past month, as concerns arose that pharmacy customers could face financial distress, and specifically, that one of **McKesson's** MCK biggest customers, **Rite Aid** RAD, could be near bankruptcy. While the loss of a major customer can have a severe effect on distributors' bottom lines, AmerisourceBergen's low customer concentration make it less susceptible to any individual client loss, which should alleviate investor fears.

Fresenius Medical Care FMS

Fresenius has experienced a sharp decline in share price over the last several weeks, and we are somewhat perplexed by the recent deterioration; our long-term view on the company is still intact. We think that investor concerns have been sparked primarily by regulatory fears. We concur that Medicare could change how it compensates dialysis clinics for administering anemia drugs, such as Epogen, which would have an effect on the company's margins; the health-care reform discussion likely reignited this fear. However, there are no imminent changes on the regulatory front as of yet, and Fresenius' position as the dominant player in both dialysis products and services remains secure. We continue to believe that the company will take advantage of the growing demand for dialysis treatments overseas, and we expect the current global recession will have little to no effect on demand for the company's services.

Alex Morozov, CFA, does not own shares in any of the securities mentioned above.

Our Outlook for Industrials Stocks

The near-term outlook for industrials companies remains muted.

By Adam Fleck

As expected, industrial firms entered 2009 with a whimper. Continued weakening of the global economy has led to sharp industrial-production declines and massive employee layoff announcements from many of the major names we cover. We expect the near-term environment to remain dreadful for industrial companies. Still, there are some positive signs, but it's too early to say for certain whether the sector will finish the year with a bang, and we're definitely not ready to call a bottom.

By most measures, the worldwide economic picture worsened through late 2008 and early 2009, as the gross domestic product (GDP) of most industrialized nations fell or slowed. The United States saw a 6.2% annualized fourth-quarter GDP drop, and the first quarter isn't shaping up much better. Critical to our coverage space, industrial production fell 1.4% sequentially in February (after dropping 1.9% in January), and dropped below 2002 manufacturing levels. Key components of this index include automotive production, new home starts, and aircraft construction, all of which continue to suffer from slackened consumer demand. Retail sales of new cars fell in February to an annualized level of 7.5 million from over 8 million in the last quarter, housing starts remain at unprecedentedly low levels, and **Boeing** BA has suffered immensely from a worker strike during the fourth quarter.

The pain hasn't been isolated to the U.S., either. Eastern Europe—until recently a hotbed of economic growth—is facing enormous challenges and threatens to upset Western Europe's already-struggling economic circumstances. Asian stalwart China even saw its seemingly immune GDP growth slow recently, and precipitously declining iron-ore shipping rates suggest that the country's industrial production hasn't meaningfully rebounded in the first quarter. To make matters worse for U.S.-domiciled companies selling overseas, the dollar has maintained its strength over the past several months. These firms will report less dollar revenue per local-currency sale as a result, further challenging year-over-year comparisons.

In response to the deteriorating economic condition and still-muted outlook, several of the largest companies we cover have announced major layoff plans. For instance, **United Technologies** UTX plans to let go of 11,600 employees over the year, **Caterpillar** CAT looks to shed 22,110 people, and FedEx FDX will trim 900 jobs, (2.6% of its workforce). As these and other job cuts filter through the economic system, we expect consumer spending to continue its downward trend, further impacting firms such as **3M** MMM and **General Motors** GM.

Moreover, many of the firms on our coverage list are incredibly capital-intensive, and they have a hard time spreading less revenue over a fixed cost base. As a result, operating margins are likely to continue their downward march; it's likely that the profitability seen over the past few years won't be generated again for years to come. Some companies—such as shipowner

DryShips DRYS and autoparts supplier **American Axle** AXL—have blown through financial covenants. Although banks have thus far been willing to renegotiate debt agreements, they may not be so kind if conditions worsen materially. As it is, these high-debt companies will likely face substantially higher interest costs, accelerated principal payments, or both. For several companies we cover, we factor a high degree of insolvency risk into our discrete scenario analysis.

Nonetheless, some positive trends have appeared on the horizon. For one, lower oil prices have benefited consumers at the fuel pump. If drivers continue to shell out less for gasoline, they will likely have more in their wallets to spend. Another positive, **Boeing's** BA production rebound after its fourth-quarter strike could boost first-quarter numbers. Continued global governmental stimulus packages—if successful—could also generate demand for construction and the infrastructure to support it. However, any potentially meaningful benefit is likely several quarters out.

Valuations by Industry

Considering our multiyear focus, it should come as no surprise that we view most of our coverage list as attractively valued even though near-term results will likely remain dim. Overall, the sector's average price/fair value ratio is 61%. The majority of the companies we follow operate in violently cyclical industries, and the current downturn has been exacerbated by the worldwide recession. Although demand will inevitably again return, uncertainty abounds. That said, as demand picks back up, we think the machinery, transportation, and materials necessary to support infrastructure projects will strongly benefit; these industries are amongst the cheapest for long-term investment.

Industrials Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Aerospace & Defense	4.4	0.59	0.73	-19	56.7
Agricultural Machinery	4.3	0.59	0.67	-12	22.0
Air Transport	3.2	0.69	0.95	-27	96.9
Automakers	4.0	0.59	0.57	4	62.2
Auto Parts	4.0	0.59	0.61	-3	55.1
Auto Retail	3.0	0.93	0.81	15	29.9
Building Materials	4.0	0.57	0.62	-8	65.4
Construction Machinery	4.7	0.49	0.59	-17	40.9
Distributors	4.3	0.73	0.67	9	26.8
Diversified	4.6	0.52	0.66	-21	33.9
Electric Equipment	4.0	0.69	0.59	17	47.2
Environmental Control	3.7	0.61	0.74	-18	52.0
Homebuilding	4.1	0.53	0.56	-5	85.8
Land Transport	4.9	0.57	0.58	-2	12.6
Machinery	4.8	0.53	0.60	-12	24.4
Manufacturing	5.0	0.48	0.50	-4	50.4
Metal Products	3.8	0.62	0.62	0	72.4
Packaging	4.2	0.65	0.69	-6	29.1

Industrials Industry Valuations (continued)

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Paints/Coatings	3.0	0.87	0.92	-5	60.6
Transportation-Misc	4.9	0.55	0.65	-15	15.7
Truck Makers	4.6	0.58	0.64	-9	25.2
Water Transport	4.5	0.46	0.53	-13	67.7

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Industrials Stocks for Your Radar

Given the current economic malaise, we think it's critical to keep strong companies with pristine balance sheets on your radar. Even though economic activity will eventually again pick up, some companies may not make it to the other end of the tunnel due to high degrees of financial leverage. These firms, which have very little debt, are worth keeping on your watch list.

Top Industrials Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
Aptar	★★★★★	\$47.00	Narrow	Medium	\$27.96
Expeditors Intl. of Washington	★★★★★	\$44.00	Wide	Medium	\$28.75
Ritchie Brothers Auctioneers	★★★★★	\$20.00	Wide	Medium	\$16.98
St. Joe	★★★★★	\$50.00	Wide	High	\$15.46

Data as of 03-18-09.

Aptar ATR

As a custom dispenser-pump designer and manufacturer, Aptar's product offering is typically more recession-resistant than many other firms we cover. Although the firm's volume has suffered from the "empty-pantry" effect (in which consumers slow their own replacement cycle of dispensable products such as creams, condiments, and medicines), we think staple items such as ketchup and shampoo will generally remain in demand throughout the downturn. With a paltry \$100 million in net debt, Aptar looks to maintain its market-leading share.

Expeditors International of Washington EXPD

Featuring a dynamic business model and stellar execution, this third-party logistics firm has consistently generated terrific returns on its invested capital. Although volume headwinds will likely challenge the firm's top line for several quarters, Expeditors' variable cost structure should preserve profitability during the downturn. With zero long-term debt and nearly \$750 million in cash at the end of 2008, we think the company is well-positioned to outlast continued weakness.

Ritchie Brothers Auctioneers RBA

The world's largest industrial auctioneer, Ritchie Bros. has carved a profitable network for the sale of construction, agriculture, and other industrial equipment. The firm's terrific working capital management and net cash position (more cash than long-term debt) should serve the

company well as it continues to expand within the highly fragmented industrial-equipment resale market. On top of that, Ritchie Bros. has a history of producing solid performance throughout economic cycles. In fact, the company has failed to achieve year-over-year top-line growth only once during the last 40 years.

St. Joe JOE

As a real estate developer with substantial land holdings in Florida (one of the weakest real estate markets in the country), St. Joe doesn't immediately seem like a prime investment candidate. However, the company dominates the state's northwest coast, and holds its land at near-zero cost. With \$116 million in cash and only \$50 million in debt, the firm has lots of time to wait for the eventual rebound in land value.

Adam Fleck does not own shares in any of the securities mentioned above.

Our Outlook for Media & Telecom Stocks

The weak are starting to fall by the wayside in media and telecom.

By Michael Hodel, CFA

Last quarter we highlighted the extreme divergence between the good and the bad within the media and telecom sector, and things have only gotten worse for weaker firms over the past three months. Most notably, the bleak picture we painted for telecom equipment vendors, especially **Nortel** NRTLQ and **Alcatel-Lucent** ALU, is now painfully visible. Nortel filed for bankruptcy protection in January and Alcatel-Lucent limped to the finish line in 2008, posting yet another weak quarter, with sales declining and cash flow anemic. We're still skeptical that Alcatel can turn its business around any time soon, if at all, in what will likely remain a very challenging environment through at least the first half of 2009. **Ciena** CIEN CEO Gary Smith nicely illustrated the woes in the sector after his firm reported weak quarterly results, stating that many service providers are now setting monthly, rather than annual, equipment spending budgets in response to ongoing uncertainty in global economies.

Few firms have escaped the downturn in equipment spending and **Cisco** CSCO, our industry favorite, is no exception. The firm experienced a sharp decline in demand in its first fiscal quarter, and it expects a 15%–20% year-over-year decline in second-quarter revenue. Cisco recently confirmed long-standing rumors that it will indeed enter the server market and singled out **Hewlett-Packard** HPQ as its primary competitor. While we doubt this move will meaningfully change Cisco's near-term operating results, the long-run implications could be significant. The server industry is mature and highly competitive, and we think Cisco will have a difficult time earning an acceptable return on the capital it deploys for these efforts. Moreover, Cisco may be placing a portion of its enterprise networking revenue at risk as HP, **IBM** IBM, and **Dell** DELL re-evaluate partnerships. We'd like to see Cisco spend more time tending to its wide moat, beating up on weakened rivals; the planned acquisition of Pure Digital, a maker of handheld video cameras aimed at consumers, adds to our worry that the firm is pushing into unattractive markets in search of growth. Cisco's advantages relative to the competition are so great, however, that we still believe the firm will extend its lead over the next couple years.

The recession also continues to take a toll on media firms, especially those that rely heavily on advertising, and we remain bearish on most "old media" stocks, especially newspapers and radio. These firms have been hit by a triple-whammy: large sales declines driven by the economy, ongoing secular shifts away from traditional advertising, and—most devastating—highly levered balance sheets. The fallout from past excesses in these industries continues to mount, with E.W. Scripps' SSP Rocky Mountain News closing its doors in February and Hearst's Seattle Post-Intelligencer ditching its print product this month. Both firms failed to find a buyer for their respective papers in recent months and decided to put an end to 150 years of tradition rather than spill yet more red ink. We've assigned a \$0 fair value estimate to three additional media firms over the past quarter, bringing the total to 14, or about 20% of our coverage list in the sector.

We don't think any media companies are immune from the weak ad spending environment that will persist during 2009. For example, we made a slight reduction to our fair value estimate for Google in January to account for lower sales growth in 2009. We still like the long-term growth prospects for search advertising, however, and we believe Google's moat in this key business continues to widen. Advertising spending on cable television networks grew around 3% in 2008, but we think sales are likely to decline slightly in 2009. However, unlike newspapers and radio, we like the long-term prospects of cable networks, which garner stable subscription fees in addition to ad dollars. Some of our favorite media names such as **Disney DIS**, **Time Warner TWX**, and **Viacom VIA** own attractive cable networks.

Even firms with businesses that have held up relatively well haven't been able to escape the effects of excess debt. **Charter Communications CHTR**, like its cable peers, has seen only a modest slowdown in growth recently. We mentioned last quarter that cable companies were starting to gain significant ground in the battle for customers with telecom rivals, including giants **AT&T T** and **Verizon VZ**, but that the telcos were fighting back by cutting prices. The result was a shift in market share back toward the phone companies during the fourth quarter. We don't believe price cutting is a viable long-term strategy for the telcos—both phone giants saw margins in their fixed-line businesses contract sharply in the fourth quarter—and we expect cable will continue to gain share in most markets over time. In this environment, however, any sign of weakness is big trouble for firms as heavily levered as Charter (debt roughly equal to 10 times operating income, excluding depreciation and amortization expenses). With grim refinancing prospects, Charter is seeking bankruptcy protection.

Outside of the U.S., most phone companies face less-intense cable competition and these businesses continue to hold up fairly well as more customers adopt wireless and high-speed Internet access services. Although we have seen growth suffer recently as customers cut back on wireless usage, most of the telecom carriers we follow continue to generate significant amounts of free cash flow, which we expect will provide stability through the downturn. Some of the more leveraged international firms, such as **BT Group BT**, **Telecom Italia TI**, and **Telenor TELNY**, have seen their stock prices pummeled on concerns about their ability to service debt, in addition to select company-specific issues and negative currency swings. We believe there are telecom opportunities outside the U.S., but investors can afford to be choosy.

Valuations by Industry

Valuations in the media and telecom industry headed mostly lower again during the first quarter, but volatility was much less severe than it was in the previous quarter. The radio industry jumps out as an exception and the accompanying figure seems to indicate that the industry got a lot cheaper over the past three months. That isn't the case, however. Our calculation excludes stocks with \$0 fair value estimates to eliminate the impact of deadbeat companies on what otherwise might be an attractive industry. We've added to the number of \$0 fair value estimates in the radio industry recently, and eight of 10 firms we cover now fall in that bucket. We don't consider the remaining two—**Cox Radio CXR** and **Entercom ETM**—particularly attractive. Broadcast television and publishing exhibit similar characteristics, as their relatively low average star ratings indicate.

Media & Telecom Industry Valuations

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
Advertising	4.0	0.61	0.64	-5	35.4
Broadcast Television	2.8	0.52	0.59	-12	78.7
Business/Online Services	3.5	0.66	0.58	14	66.9
Cable TV	4.3	0.53	0.63	-16	20.5
Data Networking	4.3	0.49	0.56	-13	14.2
Media Conglomerates	3.5	0.57	0.67	-15	33.1
Publishing	2.8	0.83	0.82	1	44.9
Radio	1.5	0.78	1.51	-48	19.7
Telecom Services	3.8	0.67	0.74	-9	45.7
Wireless Equipment	3.8	0.73	0.61	20	63.8
Wireless Service	3.8	0.60	0.69	-13	48.0
Optical Equipment	4.0	0.45	0.49	-8	34.6

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

The cable and data networking industries look especially cheap right now. In both cases, we believe the largest firm in the industry by market capitalization—Cisco and **Comcast** CMCSA—offer compelling valuations. Data networking and optical equipment also include a number of firms trading at or near the value of cash, net of debt, on their books.

Our Top Media & Telecom Picks

We've made one change to our list of top picks since last quarter: We've replaced **eBay** EBAY with Google. We recently attended eBay's analyst day and walked away happy with the firm's decision to focus more attention on its core platform, catering to used and overstock items, rather than its efforts to attract retailers of new merchandise. We made a significant cut to our fair value in January as we had clearly overestimated the market opportunity in the U.S. auction business, but we still think eBay is undervalued. Although it's not rated 5 stars, Google offers a wide moat in a business that continues to grow nicely.

Top Media & Telecom Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Price/Fair Value
Walt Disney Co.	★★★★★	\$34	Wide	Low	0.52
Google, Inc.	★★★★	\$500	Wide	High	0.66
Comcast Corp.	★★★★★	\$25	Wide	Medium	0.52
Cisco Systems, Inc.	★★★★★	\$31	Wide	Medium	0.53
NII Holdings, Inc.	★★★★★	\$43	Narrow	High	0.36

Data as of 03-19-09.

Walt Disney DIS

Although Disney is not immune to a slowdown in consumer spending, we like the long-term prospects of this wide-moat firm. About half of overall operating profit comes from its cable networks, headlined by ESPN and Disney Channel, which garner a majority of their sales from

affiliate fees. While its theme parks and studio entertainment results are taking a hit during this recession, we don't think Disney's brands are less valuable today than they were a year ago. The strength of these brands allows the company to exploit its characters and franchises through box office and home video sales, theme park attendance, and merchandising.

Google GOOG

We believe Google's wide moat comes from its dominance in search advertising. While we expect growth to slow in 2009, we think the inherent advantages of search and the continued growth of Internet usage will lead advertisers to allocate more of their ad budget to search, resulting in solid growth prospects for years to come. It was also encouraging to see Google show discipline in controlling costs in the fourth quarter of 2008. New hiring has come to a halt, capital expenditures are down, and the company is cutting back on resources allocated to business units with weak prospects. While some may view these moves as a signal that Google's growth prospects are permanently impaired, we think the company is finally focusing on its best opportunities and less on science projects.

Comcast CMCSA

Customer growth slowed sharply during the fourth quarter, but Comcast continues to expand its share of consumer telecom spending (Internet access, phone, and television services) relative to its phone company rivals. We believe the firm's solid financial position and growing cash flow position it well to remain a step ahead of the phone companies in most of the markets it serves.

Cisco CSCO

Weak near-term demand and concerns over Cisco's entrance into the server market continue to weigh on Cisco's share prices. Although we are skeptical that Cisco can succeed in the server market, we expect the company to maintain its dominance in routing, switching, and a handful of adjacent markets. Longer term, we expect network convergence, data center consolidation, and increased global communications needs to drive demand for Cisco's equipment.

NII Holdings NIHD

Weak currencies in Latin America have hurt NII as most of its revenues are generated in Mexican pesos and Brazilian reais. While the firm continues to see strong subscriber growth and increased revenue in local currencies, the majority of those gains have been lost when translated back into U.S. dollars. In addition, the firm has more U.S. dollar-denominated debt than cash held in U.S. dollars, which exacerbates the situation. With the U.S. Federal Reserve planning to buy government bonds, the U.S. dollar has recently weakened against most currencies, which should benefit NII over the near term. We also think the firm still has lots of growth potential left and that the current stock price reflects undue concern over future currency moves.

Michael Hodel, CFA, does not own shares in any of the securities mentioned above.

Our Outlook for Technology Stocks

The end of inventory destocking.

By Toan Tran

The technology supply chain is showing some very faint signs of life, and the technology heavy NASDAQ has rallied markedly since the early March lows. However, a slightly less negative information flow speaks more to the fact that few pits are actually bottomless rather than to any fundamental uptick in end demand. The good news is that much of the technology supply chain, from chips to hard drives, has done an admirable job of taking out production capacity in the last few months. As a result, inventory destocking, or the process of working off excess inventory, has run its course for now.

Most of the evidence pointing toward the end of destocking comes from the semiconductor industry. The largest outsourced semiconductor manufacturer, **TSMC** TSM, saw its capacity utilization rate drop from 100% to 40% over the past three quarters as customers cut back on production. In recent weeks, however, customers have come to TSMC with rush orders for new chips as their inventories have run low. TSMC raised its first-quarter 2009 revenue guidance by 10% and expects a double-digit sequential increase in second-quarter orders. Moving further out on the supply chain, **Microchip Technology** MCHP, the leading maker of chips that control everything from remote controls to refrigerators, also noted an increase in rush orders. Management stated, "We are seeing a high level of expedited requests from our customers, despite relatively short lead times on all of our products. We believe this indicates that customer inventories are depleted and that customer order patterns are now trying to catch up to actual demand."

Another bright spot for the semiconductor industry has been the 3G wireless build-out in China. **Altera** ALTR and **Xilinx** XLNX, the two programmable logic leaders, both were able to slightly increase their first-quarter 2009 sales expectations because of improved demand from China. Other companies, such as **Analog Devices** ADI and **STMicro** STM, should also benefit from Chinese 3G demand.

Valuations by Industry

There is a lot of noise in some of the numbers, especially in industries where there are only a handful of companies such as Audio/Video Equipment. Looking at the larger industries, however, such as Semiconductors, we see that the gap between price and fair value has shrunk over the past three months. These companies were in free fall three months ago as production ground to halt, but as inventory destocking has ended, the incremental news has turned slightly more optimistic. For example, the change in sentiment has helped TSMC shares rally nearly 30% since the last quarterly update.

Technology Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Audio/Video Equipment	3.0	0.94	0.45	108.0%	8.7
Business Applications	4.6	0.60	0.63	-4.8%	3.9
Business/Online Services	3.9	0.66	0.58	13.7%	66.9
Components	4.0	0.63	0.63	0.0%	51.2
Computer Equipment	4.7	0.67	0.58	15.5%	7.1
Contract Manufacturers	4.4	0.37	0.46	-19.6%	93.7
Development Tools	3.5	0.84	0.78	7.6%	36.2
Distributors	4.3	0.73	0.67	8.9%	26.8
Electric Equipment	4.0	0.69	0.59	16.9%	47.2
Entertainment/Education Media	3.9	0.73	0.48	52.0%	40.2
Photography & Imaging	3.0	0.86	0.54	59.2%	98.4
Semiconductor Equipment	4.4	0.50	0.52	-3.9%	52.8
Semiconductors	4.0	0.71	0.62	14.5%	48.8
Systems & Security	4.5	0.67	0.65	3.0%	32.3

Data as of 03-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

The continuing theme in technology is that high-quality companies still look cheap. Despite a substantial rebound in stock prices, the market is still offering up many cash-rich companies with solid competitive advantages and good growth opportunities at single-digit multiples.

Our Top Tech Picks

Some of our favorite technology names have rallied significantly in recent weeks. Some, like **NetApp** NTAP and **Adobe Systems** ADBE, are no longer rated 5 stars. We feel both companies should be kept on the radar screen, however, because there may yet be opportunities to buy them at great prices.

Top Tech Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Gain From 52-week Low
Apple (AAPL)	★★★★★	\$169.00	Narrow	Medium	29.9%
NetApp (NTAP)	★★★★	\$20.00	Narrow	Medium	50.7%
KLA-Tencor (KLAC)	★★★★★	\$45.00	Wide	Medium	39.1%
Symantec (SYMC)	★★★★★	\$22.00	Narrow	Medium	41.0%
Adobe Systems (ADBE)	★★★★	\$26.00	Wide	Medium	35.2%

Data as of 03-19-2009.

Apple AAPL

We believe Apple has ample growth opportunities. We think the company can continue taking market share with its Macintosh lineup in the United States, which stands at less than 10%. The new 3G iPhone also has enormous headroom for growth and will be available in more than 70 markets before the end of 2008. We believe the strategy to open up the iPhone to third-party software developers will help increase demand for the new platform.

NetApp NTAP

NetApp established itself as one of the fastest-growing companies in networked storage by offering high-end features on midrange storage systems. We think NetApp is positioned to continue capturing market share by taking advantage of emerging IT trends.

KLA-Tencor KLAC

KLA-Tencor occupies a sweet spot in the chip equipment industry because of its dominant position in the process diagnostic and control market. Given KLA's wide moat and appealing exposure to technology advances by chipmakers, we think the firm has a bright future.

Symantec SYMC

Symantec's scale advantages over smaller security software competitors should enable the company to maintain its leadership in mature security software products. The explosive growth in the use of electronic data has created opportunities for several niche players to target specific emerging threats to data security and integrity. However, such companies generally lack the scale to compete effectively in the enterprise segment, and we expect ongoing consolidation as larger players, such as Symantec and McAfee MFE, expand into growing markets.

Adobe Systems ADBE

Adobe is situated at the epicenter of several strong growth trends. The emergence of next-generation Web applications bodes well for Flash and Acrobat as tools to create and share media-rich content. In addition, the growing popularity of digital photography and video should drive sales of products such as Photoshop and Premiere.

Toan Tran has a position in the following securities mentioned above: AAPL

Our Outlook for Utilities Stocks

Utility demand and dividends come under fire.

By Travis Miller

Dividends at several struggling utilities no longer proved sacred this quarter. Falling demand and tight credit markets led three utilities—**Constellation Energy** CEG, **Ameren** AEE, and **Great Plains Energy** GXP—to chop their dividends while many others left investors with no raise. We think this illustrates that not all utilities possess the defensive characteristics that marked the industry through much of the 20th century. Still, we think several utilities can provide defensive returns for investors through these challenging conditions.

Economically sensitive energy use continues to hamstring utilities in this cycle. Officially, electricity demand fell 0.3% in 2008, only the third time in the last 60 years that electricity demand has fallen. Industrial demand was off the most, falling 2.6% in 2008 back to levels last seen in the early 1990s. Particularly in the Midwest and parts of the Southeast, we saw double-digit declines in industrial usage in the fourth quarter as the weak economy led to manufacturing plant shutdowns. Any additional deterioration in U.S. manufacturing could further erode utilities' bottom lines in certain regions.

Falling demand and more costly credit markets are leading utilities to pare back capital spending plans. Recent reports suggest half of the utilities in the U.S. have cut or deferred capital spending plans for the next several years, representing some \$8–\$12 billion of investment per year. Utilities are canceling new power plant projects that are no longer necessary as demand has flattened, and they are delaying network upgrades to conserve cash. All of this could lead to slower growth in utilities' asset bases and earnings.

The one area of utility investment that remains resilient is transmission. Federal government incentives for these projects still offer value-creation potential, even in more expensive financing markets. These projects are less sensitive to demand and can provide customer benefits through lower power prices. Many of our current favorite utility picks, such as **Westar** WR, **Northeast Utilities** NU, **American Electric Power** AEP, **Allegheny Energy** AYE, and **NSTAR** NST, are forging ahead with large transmission projects that should boost earnings regardless of demand trends.

Plans also remain intact in several states for the first U.S. nuclear power plants in more than 20 years. Georgia passed a law allowing for ongoing recovery of costs in February, a measure similar to one in South Carolina that is essential for such expensive projects. **Southern Company** SO and **Scana Corporation** SCG should benefit from these regulations. Illinois and Missouri are both considering similar provisions.

Falling demand, stagnant natural-gas prices, and political uncertainty around environmental regulations in Washington, D.C., also have created more uncertainty for independent power

producers. We still think low-cost producers such as **Exelon** EXC, **Entergy** ETR, and **Public Service Enterprise Group** PEG should benefit even in this challenging market. Other companies with strong near-term hedge positions such as **Mirant** MIR and **NRG Energy** NRG could benefit if energy prices begin to rally beyond 2009, as the futures markets and our research indicate they should.

Despite the challenging market conditions, we think several utilities possess those defensive characteristics that many investors expect from the industry. Strong regulatory relationships, credit market access, and low-cost operations are some of the keys we think will separate the best utilities from the rest of the pack and help investors earn strong returns through the bear market.

Valuations by Industry

The median price/fair value estimate for the utilities sector now stands at 0.77, down 9% from December. Although we view utilities as significantly undervalued, we also consider it the most expensive sector (on a price/fair value basis) in our coverage universe.

Utilities Industry Valuations

	Star Rating	Price/Fair Value	P/FV Three Months Prior	Change (%)	Uncertainty Percentile**
Electric Utilities	4.0	0.76	0.86	-11.6	26.0
Natural-Gas Utilities	3.6	0.81	0.84	-3.6	23.6
Water Utilities	3.5	0.80	0.95	-15.8	31.5

Data as of 3-13-09.

*Market-Weighted Harmonic Mean

**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Demand patterns and energy prices are key in determining which utilities will outperform in 2009. The sharp fall in spot natural gas prices during the last three months and President Barack Obama's unveiling of an aggressive environmental policy proposal led to a drop in stock prices for most of the independent power producers. However, we generally maintain our opinion that many of these power generators have substantial upside beyond 2010 because of the supply-demand imbalance that could emerge in the power and natural gas markets. A faster-than-expected economic recovery could produce considerable upside for both independent power producers and regulated electric and natural gas delivery firms. Even favorable weather conditions in 2009 could lift earnings for many of these companies. Currently, we expect a second consecutive year of falling electricity demand in 2009 followed by a recovery in 2010. Those utilities serving areas with resilient energy demand or that have less demand-sensitive earnings should outperform.

Our Top Utilities Picks

Independent power producers with low-cost operations and strong near-term hedges are in a strong position, in our opinion. That group includes 5-star picks **Exelon** EXC and **Mirant** MIR, and 4-star picks **Entergy** ETR and **Public Service Enterprise Group** PEG. Among regulated

utilities, we think historically high dividend yields and cash flow growth potential at **Westar WR**, **Southern Company SO**, **Northeast Utilities NU**, and **NSTAR NST** can provide strong investor returns through this downturn.

Although we believe the long-term fundamentals for the utilities industry are solid, we have assigned a 5-star rating to only seven of the firms we cover. As the economy recovers, however, we could see more-attractive opportunities emerge among some of our top merchant and regulated utilities. As such, we recommend keeping these stocks on your radar screen.

Top Basic Materials Sector Picks

	Star Rating	Fair Value Estimate	Economic Moat	Fair Value Uncertainty	Dividend Yield
Exelon EXC	★★★★★	\$76	Wide	Medium	4.7
Westar WR	★★★★★	\$27	Narrow	Medium	6.9
Southern Company SO	★★★	\$34	Narrow	Medium	5.5
NSTAR NST	★★★	\$35	Narrow	Medium	4.8
Northeast Utilities NU	★★★★★	\$26	Narrow	Medium	4.4

Data as of 3-19-09.

Exelon EXC

Because of its low-cost nuclear power plants, Exelon is the only utility we cover that has earned a wide-moat rating. Despite a fall in power prices, we believe Exelon's long-term fundamentals remain intact. Management has demonstrated a long-standing commitment to creating shareholder value through stock repurchases and dividend hikes. As of March, Exelon had hedged substantially all of its power production and fuel costs for 2009 and 2010. This should lend stability to Exelon's earnings in today's turbulent market.

Westar WR

A stable, constructive regulatory environment in Kansas underpins a 10-year, \$3 billion capital investment plan Westar began in 2006. Two thirds of that build-out is either complete or fully approved, and the company is only now beginning to collect the higher returns on those projects. As rates adjust higher in 2009 and 2010, we expect Westar will post industry-leading earnings growth and returns.

Southern Company SO

Southern has garnered envious regulatory relationships by providing comparatively cheap, reliable power to its customers. As a result, the firm enjoys industry-leading allowed returns on equity. Southern's strong earnings growth prospects, rock-solid financial condition, and appealing dividend yield justify its place as a core holding in most income investors' portfolios.

NSTAR NST

We think Boston-based NSTAR, a fully regulated transmission and distribution utility, will continue to outshine its peers. NSTAR's strength is its predictable, rising cash flow. Strong cash flows, in turn, have translated into an impressive record of dividend increases. We expect the

firm will continue its dividend growth at a healthy 5%–6% pace for at least the next five years. For risk-averse, income-seeking investors, we think NSTAR is among the most attractive firms available.

Northeast Utilities NU

Transmission investments are the primary growth driver at Northeast Utilities. It recently raised its dividend 12% behind the cash flow being generated from just-finished transmission lines stretching across Connecticut. New projects with incentive regulated returns throughout New England could provide earnings growth for the next five years regardless of economic conditions. Tough New England renewable energy goals provide additional growth opportunities.

Travis Miller does not own shares in any of the securities mentioned above.