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VOLUME 8

ISSUE 2

JANUARY 20, 2006

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listeningin

Stan Nabi, Tempered Bull

Calling Market Fundamentally Undervalued But Angst-Ridden, He’s A Picky Buyer

Lazard Freres, Bessemer Trust, Donaldson, Lufkin & Jenrette, Credit Suisse Asset Management—

Stanley A. Nabi has had corner offices on high in many of the toniest shops in the Street. But Stan clearly relishes his current gig, as Vice Chairman and Chief Investment Strategist at Manhattan-based Silvercrest Asset

Management Group, an independent “thinking boutique.” Something which, on the available evidence, the investment advisory firm does quite well. Founded just four years ago, by a couple of other former DLJ execs, G. Moffett Cochran and Martin Jaffe who, like Stan, did brief stints at Credit Suisse after it acquired DLJ, employee-owned Silvercrest has grown to \$6.4 billion under management for wealthy families and a few institutions. I called Stan early this week after reading his eloquent and persuasive January letter to clients and he was gracious enough to share not only his market outlook, but a hefty list of solid companies whose shares, he figures, will produce handsome gains over the next 3-5 years.

KMW

Your recent letter to clients struck me as an oasis of measured reason in a market that,



almost to the degree of Washington, seems to be populated only by zealots. You came across as neither a gloom and doomer nor a rabid bull—

Well, our bottom line is that the market is fundamentally undervalued on any major metric you care to look at. But it is burdened by anxiety, frustration, unease—whatever you want to call it—and that is not because of economic fundamentals. It is just psychology.

You described the market as a “sedated bull,” a wonderful image.

Yes. I don’t think we’ve had a period as frustrating as the present since the early 1970s. But back then, we had deteriorating economic fundamentals. We had high and rising interest rates, they were actually escalating very rapidly. We had high inflation. And it was escalating rapidly. We also had a loss of faith in the government in Washington.

lating rapidly. We also had a loss of faith in the government in Washington.

Courtesy of Tricky Dick, Vietnam and Watergate.

Yes, we had just gone through a war that—whether we liked to admit it or not—we had lost. By contrast, in the current situation, the only similarity that we have is the situation in Washington. On that score, I don’t

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welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street, Greenwich, CT 06830. Telephone: (203) 861-9814. Fax: (203) 618-1752. Email: welling@weedenco.com, jean_galvin@weedenco.com.

First-class postage is paid at Stamford, CT.

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Charles Powell

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think you can talk to too many people who are happy with what President Bush is doing. I voted for him, for example, but I don't think that Bush is doing a good job and I doubt that, given an opportunity, I would vote for him again.

Depending, obviously, on whom the Democrats found to run against him.

Unfortunately, that is *truly* the problem. If you could check my voting records, they would show that I am a true independent. You'd see any number of times, for instance, when I voted for a Republican for President and a Democrat for the Senate, or vice versa.

I hear you.

But in the current situation, I just keep asking myself whether Bush was the best man we could have elected. Whether he has the gravitas to be President of the United States and leader of the world. Events keep happening that tell me the answer is negative. But in any case, I have never seen psychology on the political front as bad as it is now. And this negativity is spilling onto the economic front. Let me be clear here. I am talking about sentiment, *not* economic fundamentals. If you tell people that corporate balance sheets are great, corporate profits are great, their response is, "But how long is this going to last?" That is what is burdening the market. But what this tells me is that this is a low-risk market, even though its potential on the upside is not explosive.

Low risk, how?

If you take the Standard & Poors 500, and look at the 25 companies in the index with the largest market caps right now, they are trading at a discount to the index's P/E—they have not sold at this low a relative P/E in, gosh, 15 years. Since 1993-1995.

True enough. But valuations are much higher for a broad swathe of companies in the mid-cap arena.

Yes, that is true. These mega-caps are companies that are maturing or have matured. But if you look at some of these companies—take a look at **Home Depot (HD)**, for example, which is one of the 25. If you go back five or six years, this stock was selling at 70 times earnings. Right now, it is trading at under 14 times the next 12 months' earnings. That is just one example. So I feel comfortable that this a low-risk market. But I also believe that it only has modest upside potential over the next 12 months.

What sort of returns are you anticipating?

I think we're only going to see a slight P/E expansion. I'd be surprised to see them expand by more than one multiple. We'll add to that about a 6%-8% increase in profits, and a dividend, so that means we will get about 10-13% return this year. That's what should be doable without taking too much risk. And any surprise, I would think, would be on the upside, if there is any change in psychology.

And you see that upside in the S&P 500 index, not just in the downtrodden mega-caps?

Absolutely, that's for the broad index, not just for the 25 largest cap stocks. There are certainly stocks that are not among the 25 biggest that have real upside potential—and I'll talk about some today.

So you aren't expecting another frustrating year like 2005, when if you weren't in certain sectors, you went nowhere—or worse.

No, we had really a deteriorating situation last year. I kept on hearing, even from some people who aren't very sophisticated, that "You don't fight the Fed." It was almost a kneejerk reaction, "the market doesn't go up when the Fed is raising interest rates." What all

these people were missing is that Greenspan *never* should have gone as low as he did on the Fed funds rate. His last two reductions were unnecessary—but having cut rates that far, he had to pull them back up and prepare the Fed to be able to take action, if we should ever descend into a recession. Not that I see one around the corner. I don't.

Because you're not easily spooked?

No, because you need all kinds of economic imbalances to go into a recession and we do not have them. We have a very healthy financial system. We have very healthy corporate balance sheets. We have a decent amount of growth. GDP is really based on three "engines," I call them. The first is consumer spending, which is about 65% to 70% of GDP. That is not likely to be a heavy contributor to GDP growth this year. I think that the growth in consumer spending will be considerably less than what we will show in economic growth next year. The two engines that will deliver the extra growth are 1) government spending, which is going bonkers, and 2) capital spending by business. I am estimating that government spending will grow 7%-8%—and maybe it will be closer to 10%, if you include state and local governments as well as the federal government. People often have a tendency to focus just on the federal government. But state and local spending is, collec-

"I feel comfortable that this is a low-risk market. But I also believe that it only has modest upside potential over the next 12 months"

tively, greater than federal spending and outlays by every level of government account for about 23% of GDP.

And you're expecting capital spending to wake up, too, from its long slumber?

It's true that capital spending has been slow to recover from the last recession. In fact, it was one of the slowest cap-ex recoveries we have had since World War II. It was only three or four months ago that capital spending climbed back to the high it had reached before the last recession. So companies are not being careless here. And capital spending contributes 17-18% of GDP. Now, before you object, I know those percentages of GDP that I just used add up to more than 100%—107%-108%, in fact. But keep in mind, that is because of the trade deficit, which is approximately 7% of GDP. You have to deduct that from the 107%, because it is consumption that we are not producing. So what you have here is 40% of the GDP really on fire. Very robust growth. Everybody is worrying that the consumer is not going to be a contributor—but so what?

"So what?"

In this instance, I'd rather the consumer *not* be a contributor. Why do I need the consumer to grow at 5% or 6%, which would force higher inflation, which would force higher interest rates? I would rather the consumer lays back and saves a little more.

Why are you so sure capital spending is going to rev up? This expansion is already well into middle age, at the least, and cap-ex spending has been notably weak throughout.

We speak to lot of companies. At the present time, the indications we are getting is that they are going to be spending. And a good part of the spending that they are planning is for efficiency. They cannot raise prices. There is a whole world out there that is competitive. So any efficiency has to come from improving production facilities and methods. That is why I see capital spending growing at a higher rate than GDP *at least* through the middle of 2007. Also, corporations have money that they can spend. Typically, you think four times before you spend, if you have to go borrow the money at high interest rates. But if you have the cash flow, then you don't think four or five times before you spend. You think twice before you spend. That's how companies are doing things now.

So far in this expansion, more companies seem to prefer plowing excess cash into stock buybacks or dividends to try to placate shareholders, rather than into capital projects.

Or they're using it to find growth through acquisitions, rather than by adding new facilities. But we also have data on capital spending. **Caterpillar** (CAT), for example, believes that its current product cycle is going to extend into 2009-2010. They give all kinds of reasons: because of the delay in the recovery, because we didn't really have a smokestack capital spending cycle in the 1990s in companies like Caterpillar, **Emerson Electric**, **Ingersoll Rand** and the like. What we had instead back then was a technology capital spending cycle. But we are starting to see a smokestack capital spending cycle now.

You started your letter by heaping a bit of scorn on people who suggest that business cycles are "pre-ordained by some immutable celestial order, rather than shaped by events with often unpredictable and unquantifiable conse-



quences," then noted that both expansions and recessions, in the recent past, have marched to their own drummers. Yet you're not suggesting, like my friends at GaveKal, that the cycle essentially has been repealed, at least in the West?

No. I think we will continue to have business cycles. But take a look at the last two recessions. They were the mildest in the post-war period. The one in 1990 some say was triggered by the Gulf War, and the recent one, by the popping of the equity market bubble. But in both instances, the recession was very shallow, very brief, lasting only two or three quarters. What is interesting is that the last down cycle we had, in 2000-2001, was *entirely* in capital spending. If we hadn't had that cap-ex decline at that time, which was focused substantially in technology, we wouldn't have had the recession.

So you're arguing that things like globalization and technological advances are working to moderate the cycle, not eliminate it?

Exactly. And these forces aren't just moderating the cycle for this one time, they are going to be moderating it for a long time. Global competition, global markets. You can no longer talk about "domestic industries, domestic markets. All significant industries are global industries. And they have to think of themselves that way. One of Detroit's biggest problems, for instance, stems from the fact that they always looked at their domestic market, domestic production and domestic capacity. But they did not look at the global capacity. We have had a continuous 15%-20% overcapacity in auto production for years and years. That overcapacity still exists, even though plants have been closed here and abroad. Because the Big Three have closed aged factories and then turned around and built better ones, that produce more—which doesn't exactly to take overcapacity out of the system. Yet **General Motors** and **Ford** have not paid attention to the global market. Frankly, I shocked some people recently, when I was asked what I think GM should do.

Do tell.

I said that GM should shut down all of its production facilities in the U.S. and produce cars in Eastern Europe and other low-cost areas of the world, while maintaining what would become its

financing and service and marketing arm here. GM would be successful doing that.

I hope you weren't in Michigan when you made that suggestion.

No. But let me put it this way: I don't think GM is going to be able to survive in its present form. And small, incremental surgeries are not going to help. The little that labor has given up just isn't going to work. Keep in mind one thing: (and these are just estimates from the press, I have no firsthand knowledge) the labor costs of the transplants in this country are about \$32 a hour. While GM had all-in labor costs, until the recent agreement, of \$78 an hour. And the new deal didn't bring it down all that much. So they are not going to be able to compete. GM is not going to be able to take enough away from labor to be competitive.

Even if it could, it would still have two problems: building cars people want to buy—and finding people who could afford them!

Well, that reminds me of something else I wanted to bring up. The so-called "savings rate" in this country. Let me point this out: I am a little concerned about how much misunderstanding there is about our savings rate, which right now is zero—or actually negative—according to official figures. But I do not accept those numbers, I think they are faulty. The collection and the interpretation of the figures is faulty.

You're saying there's a lot of "savings" that aren't captured by the statistics?

Yes. And the biggest category of those savings is rarely, if ever, mentioned. How do we calculate the savings rate? We take personal income, we deduct from that total, taxes to arrive at disposable personal income. Then we deduct from that, consumption—and assume that what's left is "savings." Then we calculate the "savings rate."

Exactly, it's a statistical remainder.

Right, it's a residual figure. The problem is that we simply do not know how big the "underground economy" is. And your carpenter, your gardener, your plumber—whomever you pay cash to—is not going to deposit that money in the bank. He doesn't want the IRS to know about it. So he goes out and spends it. That increases consumption, but it is not recorded in income. Well, the lowest estimate I've heard about the size of the underground economy is 8% of GDP. So my bottom line, forgetting about everything else that is wrong about how we calculate "savings"—like the fact that you include in taxes the tax you pay on capital gains, but you don't include net capital gains in "income," or many other oddities involving retirement plans—is that we have a savings rate in this country that approaches 7% or 8%, and not the zero that we talk about so much now. There's been almost nothing written on the size of the underground economy. I've looked all over for data and it just doesn't exist.

Almost by definition. That's why it's called the underground economy—it's unreported.

But it certainly exists. And that's why I don't despair about the consumer being tapped out, or flat on his back and in debt to such an extent that he is never going to spend again.

I guess the real question is how fast the underground economy is growing relative to the one that can be poked, prod-

ded and measured—and how that may be affecting all sorts of official statistics. How much is underground consumption contributing to the trade deficit, for instance?

Conventional wisdom bemoans the trade deficit. We should not have it. Now I don't want to be dismissive. I think it should be a concern—\$800 billion is not sustainable. But what are the remedies for that? We either have protectionism combined with isolationism or we have taxes that will break the back of the economy. Not exactly great choices. And in particular, those who criticize us from the outside are conveniently forgetting that our \$800 billion trade deficit is equivalent to about 2.25%-2.5% of global GDP, which is about \$37 trillion. So if we, by some miracle, eliminate our trade deficit, even if it's over a period of time, what we will be doing is taking away 2.25%-2.5% of global growth. Which would drive many of the developing countries into recessions. It will make things *worse*. Yet people don't think about the consequences when they say, "Oh, there's an \$800 billion trade deficit, we have to do something about it!" To do that we'd have to play all sorts of games, add lots of taxes and fees to everything we import—which is not going to work in a world that's becoming more open by the day; where economic boundaries scarcely exist anymore. So the trade deficit, for all it is talked about, is a problem—but a problem without an evident solution.

It's also another economic statistic that isn't without problems in its collection and calculation—

Absolutely. I agree. But there are issues that make it better and others that make it worse. A lot of people—including some senior officials in our Trade Department (I have a copy of a letter written by a very high official there to *BusinessWeek* about six months ago that reflects this) are convinced that the China's figures on its exports to the U.S. are understated.

What a shock. There probably isn't anyone in China who knows what the "real" numbers are—or could even have a chance of figuring it out. The systems aren't merely lacking, the incentives are, shall we say, typically skewed. You can't believe China's numbers on much.

Not just China's. Keep in mind that a few years back, when Greece wanted to join the European Union, they simply supplied fraudulent figures about their budget deficit, their indebtedness—almost everything about their economy. But those are the figures the EU used—and everybody else uses to create economic statistics.

Greece perhaps can be excused for assuming that since it saw the EU's original members playing fast and loose with economic statistics, it should do likewise— But let's turn back to this country. You're not worried, like many strategists, that a slowing in what has been the torrid pace of the housing market will hit consumers hard?

Well, if you go back and look at housing starts in the 1990s, they averaged about 1.5-1.6 million starts annually. Yet we had a growing economy with housing growing at that rate. The demographics and everything else say that 1.7-1.8 million housing starts a year are what are needed now, so given the current level of interest rates, or even anticipated levels of interest rates, I don't think we're going to go down to 1.2 or 1.3 or 1.4 million levels. I see starts going down to 1.7-1.8 million and sitting there for a while before growth speeds up again. What happened there, really was not so much an increase in the price of housing, real estate. What happened was that during the 1990s we accumulated a little bit of requirements that we did not meet, and we made it up in the last

couple or three years of 2.1 million housing starts. So now we will go back on a track of 1.7-1.8 million annually. That is a good pace for the economy and I don't think it will break the back of the industry itself. One thing that you have got to remember, is that the last time we had a very bad downcycle in housing, not only were interest rates much, much higher, mortgages were much higher, but also the housing industry was structured very differently. There are no more (or almost no more) mom and pop shops there, that build two or three or four houses and try to make some money. Those guys are mostly working for someone else today. What we have now are large corporations that operate from hand to mouth, so to speak, in construction. They build, they sell and build more. They don't have any huge amount of inventories. Yes, there are inventories of homes on the market. But those are not by and large new homes. The inventories are of available homes—old homes and new homes, combined—and that inventory is not all that great. It could be absorbed in a fairly short period of time, especially as builders reduce the number of homes they build. So I don't see a disaster, particularly given interest rates that are in my judgment, close to a high. The Fed at worst, in my view, will go up to 5%.

You don't worry that the new Fed Head will feel a need to prove his mettle by doing something unexpected?

I don't see Mr. Bernanke rocking the boat a lot. Yes, it's true that on Jan. 31, we will go to 4.5% and he is not going to stop there, because he will want to show that he is an inflation-fighter. But that means he will go to 4.75% or 5% and that will be it. And he might not do that in two successive meetings. He will probably go to 4.75% at the meeting in March. Then he might skip raising rates at the next meeting and see what inflation does before he goes to 5%—if he even goes there. But there's no reason to go beyond 5%, within the context of relatively low 10-year Treasury rates, which impact more on mortgages than do short rates.

You're not worried by the modest and so-far sporadic inversion of the yield curve?

No, as a matter of fact, I was going to write something and call it, "The Yield Curve: Inversion, Conversion or Perversion?" Maybe you remember, many years ago, when everybody stood by their Dow Jones ticker machine every week to watch for the release of the money supply statistics.

Like clockwork.

Now, nobody pays much attention to money supply. It's the same with the yield curve. Its importance has been greatly diluted by the flow of funds into this country, No. 1. Secondly, we have a financial system that is very liquid. One of the things that has happened that I haven't seen anyone comment on is the fact that our financial system came through the last recession undented is a major plus. What happened at that time was that equity money, high-risk money, was available. So nobody was taking a lot of risk investing or buying businesses or creating businesses. Nobody went to banks or insurance companies to borrow—because the money was available elsewhere. So the financial institutions dodged the bullet and came through the recession undented.

For perhaps the first time in history—as w@w has noted. They're usually the first pillar to fall.

That's right.

And you attribute that miracle to the availability of equity liquidity?

Sure. Right now we have the same situation. Particularly in venture capital, money is available.

Oceans of it.

Although, I must say as an aside that when there is an LBO now, you have to go to institutions for a bridge loans and things of that nature, and I am watching that very closely—to see how much is happening. To give you an example, in the fight between **Johnson & Johnson** and **Boston Scientific**, over **Guidant**, if Boston Scientific wins, it is going to have to do a slew of borrowing. That would be real borrowing and relatively high risk borrowing, because Boston Scientific is not that well-heeled, financially. But to come back to the market today, I repeat, the S&P 500 is trading at its lowest P/E since 1993-1995, even though the inflation and interest rate backdrop then was quite different. Ten-year interest rates were 200 basis points higher when valuations were right where they are now. So I am not particularly concerned. I am fully invested and say to myself that the highest risk I have is that I will get very modest returns instead of great returns. Sooner or later, I am going to get a good return. Because there's a long list of stocks that aren't going to stay at their current valuations. Since I was a very young man in this business, I have asked myself every month or so, "Is the market cheap or expensive?" And what, other than the usual yardsticks, can I use to measure that? Can I construct a prudent portfolio—what I used to call an "Aunt Sophie portfolio"—and feel comfortable with it in the current market. There were times when I did not feel comfortable. For instance, throughout 1972, I couldn't create such a portfolio—

To "Aunt Sophie's" great good fortune, I'm guessing—

That's right. But today, I can create such a portfolio—even while avoiding a big slice of the market. For instance, today, I'm not interested in buying consumer staples. That group here is very difficult to deal with. Not so much because there is no spending, but because there is no growth. This is an industrial sector whose growth doesn't even track the growth of the population. Various companies come in with new products, but they steal market share from someone else. I recently met with a number of food packaging companies and I asked every one of them what kind of growth they expect. They all talked about zero to 1%, maybe 2%. Those who talked about 2% unit growth, said they'd introduce new products. Well, if you introduce a successful new consumer staple, you're going to take market share from someone else. Then too, we used to say, "Well, our domestic market may be mature, but we have foreign people buying our products." But I'll tell you, packaged foods companies are suffering *badly* in Europe. Unit growth is negative in most of Europe. Why, I don't know. Part of it may be, "I hate America, I don't want to buy your products." Maybe their own domestic products are improving rapidly in quality. But the place that used to save us—Europe—is not saving us anymore. So paying 16-17-18 times earnings for a consumer products company growing at 4%, 5% or 6% is not my idea of investing if I can buy companies growing at double digits and pay just the market multiple or even below-market multiples.

What areas do you favor, then?

That's a good question. Other than the health care area, and particularly pharmaceutical, I don't think or talk or invest in whole sectors at this juncture. For instance, I would buy **Home Depot** (HD), but I wouldn't buy **Wal-Mart** (WMT).

Why is that?

Home Depot doesn't have the sociological problems that Wal-Mart has developed. And Home Depot is making, in my judgment, proper acquisitions. They bought Hughes Supply, which I knew very well. As a matter of fact, three years ago, I bought Hughes Supply shares in the small cap fund that I manage. I remember saying at the time, "Wouldn't it be wonderful if Home Depot buys them." But when I thought about it, I added, "But they'd have to go in a slightly different direction to do that." But that is exactly what they did. Home Depot started to go after municipal services and the like and then they bought Hughes Supply. Now, Home Depot is trading at approximately 13.5-14 times next 12 months' earnings. Now, I repeat what I said a few minutes ago. This stock traded at 70 times earnings five years ago—and those were not depressed earnings. This was a growth company. Now, over the last few years, they have generated a huge amount of cash flow, they have bought back their stock, they have raised the dividend. They have a great balance sheet, and they will continue to make decent acquisitions. Meanwhile, few realize it, but Home Depot has become very successful at selling appliances. They are gaining market share, hugely.

While most of the analysts focus on the obvious fact that Lowe's, with a smaller store base, can open more new stores—

Sure, Lowe's is smaller and growing faster, but you also have to pay six multiples higher to buy it. You're taking more risk there. Another stock I am focusing on is **Black & Decker Corp.** (BDK). Now, anyone I've mentioned this to has said something like, "Ugh, who wants small appliances?" Well, Black & Decker has been out of small appliances for several years. They sold that business. Now they are in power tools. Then they say, "Oh, the housing market is going to hell, so who would want to buy power tools? Come on, power tools have to be bought—and usually not by individuals, but bought by professionals and all that. This is a stock that is trading at 11.5 times earnings, generating a huge amount of cash flow, the management is tested. So what is the risk in paying 11.5 times earnings for a company that over the last three years has grown at strong double-digit rates?"

Less than paying through the nose for Google, that's for sure. What else has caught your eye?

I have another intriguing pick right now that is rather surprising: **3M Co.**, (MMM). This stock hasn't done anything in 30 months. But in the meantime in those 30 months, its earnings are up more than 30%. It's trading at about 16.2-16.3 times its next 12 months' earnings. This is a company that has almost 30% of its revenue coming from health care—sophisticated healthcare, not from bandages and things like that. They also have optical businesses and things of that nature. Electro-optics. I see the company continuing to grow at double digits. In 2006, I expect 3M to generate at least 12%-13% growth.

You're comfortable, then, that 3M found the right guy to right its ship?

That's one reason the stock hasn't gone anywhere for a while, because they went for about six months without having a CEO. But now they have a new CEO. I must say, he's not tested at 3M, but this is a company, where all the CEO has to do is put his hands on the controls and hold steady to do well. Incidentally, I know I said I wouldn't buy any consumer staples stocks, but there is one consumer stock that I like very much, and it is not very well known: **Constellation Brands** (STZ).

You're right, it's not a household name in my house.

This may shock you, if you don't know it well, but Constellation Brands is the largest wine company in the world today, in every respect. Not just in revenues, but in cases sold, etc. It is trading at 15 times next 12 months' earnings and growing at better than 15% and will grow, we estimate, at least at that rate for the next three years at a minimum. It is also the largest importer of beer in this country. They import Corona. But they only have the west coast distribution. Now they are negotiating to get its distribution in the whole country. They are also the largest wine maker in Australia; the largest in New Zealand. They went around and made a lot of acquisitions. When I first came across this company, it has a total market capitalization of about \$300 million. Today it has a cap of \$6 billion. That has all happened in 7 or 8 years. It was known, at time (if known at all), as the producer of Manischewitz Wine. But they bought Robert Mondavi Corp. in 2004, which was undermanaged and within a very short period of time, measured in months, has been very successful.

So Constellation may be in the consumer staples business, but it's not your father's Budweiser?

Actually, I think **Anheuser Busch** should buy Constellation, because BUD has to find an avenue of growth. Another stock I find attractive is in health care: **Zimmer Holdings** (ZMH). It was a spinoff from **Bristol-Myers Squibb** (BMY). Something happened to Zimmer a few months back that I really hate. It makes me jump up and down. They missed their earnings estimates by one or two cents and the stock came down from 88 to 62.

Yikes. I guess that created a buying opportunity for you.

It did. The stock is still growing at 16%-18% a year and is trading at 19 times its next 12 months' earnings.

Didn't Zimmer also have a recall problem or something with the FDA?

No, nothing out of the ordinary. Or no more than anyone else. Stryker is their nearest competitor in orthopedic implants and it trades at 23 times earnings, or several multiples higher than Zimmer. But Zimmer is a company that has more than tripled its earnings since it was spun off four and a half years ago and is certainly in a growth market with the aging population and all of that.

You clearly like growth companies. Does that include the techs here?

In technology, I prefer the mature companies to the high-risk companies. I think **Microsoft** (MSFT) is cheap, as is **Oracle** (ORCL). Now, Microsoft is one of those companies that superficially looks like it is trading at 19 times earnings. But it really isn't, if you take out the cash and its earnings on its cash, it's only trading at about 14.5-15 times the rest of the earnings. Also, I am only valuing its investments in other companies at book value, because I don't know how to value them, but I think they are worth much more. Eventually, something is going to have to be done at Microsoft, because this company is accumulating \$9-\$10 billion a year in cash. It's a money machine. They are either going to make another distribution like they made 15 months ago, or they are going to make some kind of acquisition or buy stock. They may even have to go to a Dutch auction to buy back stock. So I think a patient investor will do very well in Microsoft.

What do you see in Oracle?

Well first, it's trading at only 13 times cash earnings. Now, some people like [Oracle CEO Larry] Ellison, and some people don't. But I think he is building the company to compete effectively with **SAP**, the German company. His two most recent acquisitions—**PeopleSoft**, people thought he wouldn't find it easy to consolidate, but he was able to consolidate it well, and now he's in the process of acquiring **Siebel Systems**, which should also help. And Ellison will make other acquisitions. I see Oracle emerging as one of the two or three surviving companies in the business.

Oracle certainly goes head to head with SAP AG in its ads—
Sure. But I'm not insisting on results overnight. I am a patient investor; my average holding period is about 5 years. I'm a low-turnover portfolio manager. I pay a great deal of attention to balance sheets, so that I won't be in trouble if companies run into a year or two of difficulties, which they sometimes do.

You haven't mentioned any financials today, Stan.

I am not an aggressive buyer of financials now, but there are a few stocks here that I am intrigued by, and some I own. I bought **Genworth Financial** (GNW), which was spun off by **General Electric** a few years ago. Now, when it was spun off it was so undermanaged, their ROE was about 7.5%, whereas the industry has an ROE of about 12%. At the time of the offering roadshow, they promised they'd bring their own ROE up to 12% by 2007. My suspicion is that they'll be at that level by the end of this year, because they are already above 10%. The stock has a book value of \$26.50-\$27. Other companies like this trade at approximately 1.5 times book and at 12-13 times earnings. Now if you buy the stock now, at 34 and a fraction—unless the company stubs its toe—there's no way that you're going to miss a 40% return over three years, or more, plus dividends. It's a stock that still intrigues me, even though I bought it much lower.

I am also intrigued by Morgan Stanley Dean Witter—or **Morgan Stanley** (MS), again now. I think the company is being put back together.

It's sure still suffering defections right and left—

Yes, but it's finally going to settle down and be the firm that it used to be. When I look at other companies of similar nature, for example, **Lazard** (LAZ), which right now is trading at some ridiculous P/E, because of the mergers and acquisitions market and because Lazard is concentrated in two areas, M&A and asset management. But if you buy MS here, at less than 12 times earnings, I don't think you'll have a lot of trouble. This is a stock that is down from 110, four years ago. So it's an intriguing recovery candidate. There are also two banks I am interested in, both of which I see as potential takeover candidates. One is **First Horizon National Corp.** (FHN), which used to be First Tennessee. It's the only bank in that area that has not been acquired. It's a good property; the stock is not expensive. The yield is better than 4%. It's an in-between size, it won't be able to survive on its own at that size; either it makes an acquisition or it's acquired. I'd bet on the latter. The other is **North Fork Bancorporation** (NFB), in New York. Everyone wants to come into this market. North Fork acquired GreenPoint Financial in 2004 and had a little bit of difficulty integrating it, but they're well along in that process now. This too is a banking company that could very easily be acquired by one of the very large banks.

You mentioned pharma as the one place you like an entire sector?

Well, there are a lot of attractive candidates there. If you can be

patient to the tune of 12-24 months, there is a great deal of money to be made in pharmaceutical stocks. Everybody knows the story of the government and the FDA and Medicare—that's why five years ago Pfizer was trading at 49 times earnings, and right now Pfizer is trading at 12 times earnings.

Don't forget the questions about their new drug pipelines—

In all instances, that pipeline now looks like it's going to be gradually refilled. But that is why I said you might have to be patient for two years. The pipeline is going to be refilled, just maybe not with blockbuster drugs like Lipitor or things of that nature. Anyway, the drug stocks that are of interest to me are (in this order): **Merck & Co.** (MRK), **Pfizer Inc.** (PFE), **Wyeth** (WYE), and **Bristol-Myers Squibb Co.** Now, if you buy all of these as a package, you get better than a 4% dividend yield. I own in various accounts, all of them. There are three other drug companies that sport a little bit higher P/Es, but boy, do they have potential. One is **Forest Laboratories** (FRX). Its problem with the *Lexapro* patent is about to be resolved in court. They just reported the last negative year-over-year comparison I expect from this point. In fact, I expected this to be a 15% grower for several years. Plus, this is a small company that sooner or later is going to be acquired—and in the last 12 months, they bought back more than 12% of their capitalization. They also have a great deal of cash on the balance sheet.

I likewise expect good things from **Mylan Laboratories** (MYL), another small company, with a \$4-\$4.5 billion capitalization. It is mainly a generic drug maker and has a variable track record. It's trading now at about 18 times forward earnings, but over the next three years, its earnings growth should exceed 20% a year—because of new products, new joint ventures and new licensing agreements. All of these have been announced, so I'm not guessing; they are all in place.

Finally, **Amgen Inc.** (AMGN) is one of the most neglected stocks around. Unfortunately, when a biotech company begins to earn good money, it becomes a pharmaceutical company—and is accorded a pharmaceutical company P/E. That is what happened to Amgen. This company will have close to a 20% increase in profits in 2006, on top of 22%-23% in 2005; on top of close to 25% in 2004. Yet the stock is trading at something like 21 times earnings. So that's my portfolio of ideas. If you put all the stocks I named together, you won't be paying more than 16-16.5 times next 12 months' earnings, on average, and should get better than 11%-12% growth in profits, likewise on average from them. Not to mention that there isn't a company among them with a questionable balance sheet.

Almost all of them pay dividends, too. You mentioned something driving you crazy when you were talking about Zimmer's earnings coming in a penny light. The Street's unholy obsession with quarterly EPS, perhaps?

That bothers me; boy, it bothers me. You might know that I taught for many years at Fordham's Graduate School of Business—

Indeed, I am aware of that facet of your long and illustrious Wall Street career—

I will not mention how many years, but it is considerably north of 40 now.

So you must have a long-term perspective on how this increasingly counterproductive obsession developed—

It stems largely from pressure from institutional portfolio managers. If you are managing a pension fund and have lagging perfor-

mance for even two or three quarters, you have the consultants for that pension fund on your back, you have your investment board on your back. That is why 85% of my personal business that I manage is high net worth individuals. I could show you certified accounts that I've managed for 25 or 30 years. One account, which is an institutional account—but it has no consultants—consists of the equity of an insurance company. They came to me and gave me \$5.7 million to run in November 1985.

They took out \$2.5 million in 1995, 10 years later, because the insurance department told them that they had too much equity. (By that time, their account was \$25 million.) Well, that account, net-net, that started at \$5 million is now \$91 million. And do you know what? 45% of the value of stocks in the portfolio are the very first stocks I bought for them when they gave me the cash. Things like Johnson & Johnson, Colgate, stocks of that nature, that now have adjusted costs of \$2.50. If you're riding a horse and the horse is not tired, why get off it? That's my philosophy.

The consultants might tell you it's grown too big for your style box or something like that— Oh, I was telling you about these quarterly earnings absurdities. When I taught at Fordham, I gave a two and a half hour lecture to the graduate students that I called, at that time "Quality of Earnings And Forensic Accounting." I started it off by taking an operating statement and a balance sheet of a company, giving it to my class, and saying, "This company reported earnings of \$2 last year. But I'm going to show you how—without breaking any rules—I can increase its earnings by about 25% and lower them by 25%. And I will not be challenged either by the accountants, the auditors, the SEC or anybody else." Then I proceeded to walk them through all kinds of things that can be done to change reported earnings per share. So Wall Street's worrying about one penny sometimes just makes my head explode. They're worrying about a penny, when what they're doing in buying a stock is buying a share in a long-term business. They're not buying one quarter's results.

No. Though unfortunately, that's what they're betting on. But you couldn't be more correct about the often subjective judgments that go into producing any financial statements.

I still remember visiting a company in the late 1970s. I liked the company, I liked their products. But I had a problem with their accounting because they were depreciating their equipment on a 9-year schedule, whereas the industry standard was a 7-year schedule. So I went to see them and one of the senior officers took me to the floor of the factory. He showed me equipment that they were using that was 15-20 years old. Then he said, "How can you tell me I can't depreciate this equipment over a

9 year period, if I can use it for 15-20 years? Who is to tell me to depreciate it over 6 or 7 years, if I can demonstrate that its average life is 14-15 years?" That's just one sort of thing that can have a big impact on the bottom line. There are all kinds of others: How to handle advertising costs? What do you do with bad debt?

Not to mention, when do you call bad debt, "bad"? The list is practically endless.

As I recall, I showed the class 131 places where you can play with the figures, though not all of them apply in every company, because it depends on the company's circumstances. I even showed them—and I apologize if this sounds self-serving. Believe me, I'm not a braggart. But long before Enron came along, I showed them how a company could sell a business that was not earning any money; put it into a separate corporation, give it its own management, load it with debt and then let 80% of it go. How they'd end up still owning 20% of it and how the spinoff will also owe them money—because they couldn't let it go without lending it any money. So that they will end up showing magnificent results without having to report the drag from this business' losses. And how they will eventually be able to write off their loans to that business as a bad debt—one that's non-recurring and so won't be included in operating profits. It's a dance many a company has become quite accomplished in.

Also one that Wall Street analysts have been trained to pay no attention to. A "non-recurring" event? Not to worry. Even if they are annually re-occurring.

Do you know how many companies there are right now that show a very substantial book value—but actually have no book value, if you subtract all of their intangible assets?

I can't cite a number, but I'd wager it's huge.

I'd wager you'd be right. Companies create humongous slugs of goodwill in acquisitions and then just write them off. So they don't have to amortize the cost, and the acquisition is suddenly "profitable." It's everybody's fault, it's the analysts' fault because they don't raise their voices. It's the accounting profession's fault for not raising objections. It's the SEC's fault for not objecting. Even some of the very bright young analysts here, when I walk into their offices, will tell me the book value of a company is this or that. But when I ask, "Now how much of that is intangible?" they say, "What's the difference?" Well, to me, it makes a big difference. Yes, you're buying the stream of future earnings, but also you're buying the hard assets that generate those earnings.

Amen. Thanks, Stan.

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