

20 Most Attractive Stocks for August

20 Large/Mid Cap and 20 Small Cap Stocks

Investment Perspective

The report presents unique investment ideas produced by our analysis of SEC Filings for over 3400 companies.

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Note

This document is available to clients in the **Research** area of our site www.newconstructs.com.

- **Our Most Attractive Stocks offer unique investment ideas generated by our analysis of SEC filings, especially the Notes to the Financial Statements.**
- **3 new stocks make our August Large Cap list.**
- **4 new stocks make our August Small Cap list.**
- **Figure 1 lists the tickers added to and deleted from our Large and Small Cap Lists. Appendix 1 details the reasons behind each addition and deletion.**
- **Our Most Attractive Stocks have RISING ROICs, which means the economics of the business are improving.**
- **Our Most Attractive stocks are also very cheap, with low expectations for future cash flows and current Free-Cash-Flow Yields greater than 5%.**
- **Figures 2 and 3 provide the full list of 20 Large Cap and 20 Small Cap Attractive stocks.**
- **Pages 2-4 explain our Most Attractive stock selection methodology.**

Figure 1: Most Attractive List Changes for August

	Additions	Deletions
Large and Mid-Cap	USG ALV BSC	MEL TSN VPI
Small Cap	BHO FNLY RHB PLFE	DITC INTL STRT BDY

Sources: New Constructs, LLC

20 Most Attractive Stocks: Methodology

We determine the Most Attractive Stocks based on three criteria. The stocks exhibit:

1. **Cheap valuations** because their *Price-to-Economic Book Value* (EBV) ratios are less than or equal to 1.6 and greater than 0, and they have *Growth Appreciation Periods* (GAP) less than 10 years.
2. **Strong economic performance** because their Returns on Invested Capital are rising (Upward Trend in ROIC) and they generated positive Economic Earnings in the last fiscal year.
3. **Hidden value** because their (unlevered) Free-Cash-Flow Yield is greater than 5%. Free-Cash-Flow Yield equals unlevered Free Cash Flow divided by Enterprise Value.

We do not predict the future value of stocks.

Identifying Cheap Valuations. The Most Attractive stocks have valuations that reflect reasonable expectations for future financial performance compared to historical performance. In fact, many of the Most Attractive companies need to grow their profits very little to satisfy the expectations embedded in their valuations. Rather than predicting a warranted or future value for a company or stock, we measure **the market's** prediction for the financial performance of companies as reflected in stock prices. Our measures of valuation are intentionally objective. Our goal is to position investors to make informed decisions about whether or not they agree with the market's prediction for the future financial performance of companies.

Our valuation analysis focuses on assessing the feasibility of future financial performance requirements embedded in stock price.

In our opinion, a more rigorous way to assess the valuation of stocks is to look at two metrics: the ratio of *Price-to-Economic Book Value* (EBV)¹ per share and the market-implied *Growth Appreciation Period* (GAP). The ratio of Price-to-EBV highlights the degree of difference between the company's current level of cash flow and the level of future cash flow that the market expects. Economic Book Value essentially measures the perpetuity value of the company's current annual after-tax cash flow (NOPAT). The smaller the Price-to-EBV ratio, the less improvement in cash flow is required to justify the stock price. The market-implied GAP measures the number of years the company must grow its economic profits in order to justify its stock price. The shorter the GAP, the fewer years a company must maintain a competitive advantage and earn returns above its cost of capital on new investments.

New Constructs rectifies accounting distortions in GAAP financial statements.

Identifying Strong Economic Performance. The most Attractive stocks also have reported profits that tell a different story than the economics of their businesses. There are many ways that GAAP profits can differ from Economic Profits. Scandals at Enron, Worldcom, Adelphia, and others provide evidence of just how far companies can stretch accounting rules in order to appear more profitable than they truly are. New Constructs

¹ Economic Book Value (EBV) measure the no-growth value of the business based on its annual after-tax cash flow. The Formula for EBV is: (NOPAT / WACC) + Excess Cash + Non-operating assets – Debt (incl. Operating Leases) - Value of Outstanding Stock Options – Minority Interests.

rectifies accounting distortions in order to provide investors with a cleaner and truer analysis of a company's profitability. Our process involves digging vigorously into SEC filings, especially the Notes to the Financial Statements in order to gather, model, and deliver the economic results of a company's performance.

The metrics we use to measure the economic performance of companies are Economic Profit Margin and Economic Earnings. The Economic Profit Margin for a company equals its Return on Invested Capital (ROIC) minus its Weighted-Average Cost of Capital (WACC). The Economic Earnings of a company equal its Economic Profit Margin multiplied by its Invested Capital. We believe our measures of economic performance are substantially more accurate than accounting metrics because we make adjustments for all the issues listed in Figure 1.

Cash is king.

When reported earnings and economic cash flow diverge, the market follows cash.

Identifying Hidden Value. Attractive stocks exhibit higher Economic EPS growth than GAAP EPS growth. In addition, these stocks have hidden value since their Free-Cash-Flow Yields are at least 5% of their market value. We calculate Free Cash Flow according to our economic (as opposed to traditional accounting) methodology, which account for all the accounting issues in Figure 1. .

Conclusion

Companies that have cheap valuations, strong economics and hidden value present investors with lower risk of downside and greater potential for upside performance. We believe these stocks present investors with stock that offer attractive risk/reward.

We consider companies whose Price-to-EBV ratios are less than or equal to 1.6 but greater than 0 and whose market-implied GAPs are less than 10 years to have **cheap valuations**.

We consider companies with rising returns on capital and positive Economic Earnings to have **strong economics**.

We see **hidden value** in companies whose Economic Earnings growth is positive and whose Free-Cash-Flow represents more than 5% of Enterprise Value.

The top 20 companies that exhibit all of these characteristics are the Most Attractive in the market, in our opinion.

The 20 Most Attractive Stocks for August – Large and Mid-Cap Stocks

Figure 2: Ranked by 2-yr Average Free-Cash-Flow Yield in Descending Order

Rank	Ticker	Company Name	Cheap Valuation		Strong Economics		Hidden Value	Market Value (\$mm)
			Price-to-EBV	Market-Implied GAP (years)	Upward Trend in ROIC	Positive Economic Earnings per share	FCF Yield Greater than 5%	
			as of 08/01/05	Last Fiscal Year		2yr Average		
1	LPX	Louisiana-Pacific	0.4	Less than 1	10%	\$2.80	24%	\$2,905
2	MWD	Morgan Stanley	1.4	7	0%	\$1.11	22%	\$57,300
3	CNF	CNF	1.1	9	6%	\$1.27	17%	\$2,603
4	MRK	Merck	0.9	6	4%	\$1.69	12%	\$68,922
5	TMK	Torchmark	1.0	3	1%	\$1.73	11%	\$5,755
6	FMC	FMC	0.8	5	3%	\$1.62	11%	\$2,192
7	TSO	Tesoro	0.4	Less than 1	7%	\$6.36	9%	\$3,158
8	SVM	ServiceMaster	0.8	7	6%	\$0.72	9%	\$3,992
9	IR	Ingersoll-Rand	1.2	6	3%	\$1.14	8%	\$13,547
10	UST	UST	0.9	Less than 1	1%	\$3.16	8%	\$7,601
11	PCU	Southern Peru Copper	0.5	Less than 1	28%	\$6.25	8%	\$4,097
12	USG*	USG	0.4	Less than 1	6%	\$2.32	8%	\$2,104
13	ALV*	Autoliv	1.0	1	2%	\$1.49	8%	\$4,197
14	ACN	Accenture	0.9	Less than 1	6%	\$1.75	8%	\$13,855
15	APC	Anadarko Petroleum	0.8	Less than 1	3%	\$3.43	7%	\$22,088
16	HUBB	HUBBELL	1.4	7	5%	\$1.21	7%	\$2,756
17	AT	Alltel	1.2	7	0%	\$0.49	7%	\$20,435
18	BSC	Bear Stearns Companies	1.3	8	3%	\$1.99	7%	\$13,016
19	TCB	TCF Financial	1.2	3	1%	\$1.02	7%	\$3,753
20	HBAN	Huntington Bancshares	1.1	8	0%	\$0.46	7%	\$5,734
	SPX	S&P 500	1.6	23	1%	\$0.15	0%	

* Denotes stocks that have not appeared on the Most Attractive list within the last 3 months. See Appendix for details.

Sources: New Constructs, LLC

The 20 Most Attractive Stocks for August – Small-Cap Stocks

Figure 3: Ranked by 2-yr Average Free-Cash-Flow Yield in Descending Order

Rank	Ticker	Company Name	Cheap Valuation		Strong Economics		Hidden Value		Market Value (\$mm)
			Price-to-EBV	Market-Implied GAP (years)	Upward Trend in ROIC	Positive Economic Earnings per share	FCF Yield Greater than 5%		
			as of 08/01/2005	Last Fiscal Year		2yr Average			
1	UHAL	Amerco	0.9	Less than 1	5.9%	\$2.25	69%	\$1,203	
2	NL	NL Industries	0.2	Less than 1	103.6%	\$6.85	63%	\$846	
3	WLDA	World Airways	0.7	Less than 1	3.1%	\$1.32	24%	\$165	
4	HAMP	Hampshire Group	0.8	Less than 1	4.1%	\$1.09	19%	\$184	
5	TRMK	Trustmark	1.2	Less than 1	3.1%	\$0.59	18%	\$1,658	
6	BHO*	B&H Ocean Carriers	0.6	8	14.5%	\$0.96	18%	\$68	
7	NAFC	Nash Finch	0.7	3	2.3%	\$1.67	15%	\$513	
8	CTCO	Commonwealth Telephone Enterprises	0.9	5	5.2%	\$2.08	14%	\$913	
9	IIG	Imergent	0.3	Less than 1	17.4%	\$3.14	14%	\$129	
10	MBVT	Merchants Bancshares	1.0	Less than 1	5.4%	\$1.09	13%	\$172	
11	MFW	M & F Worldwide	0.5	Less than 1	1.7%	\$0.71	13%	\$253	
12	TONE	TierOne	1.4	7	3.8%	\$0.30	13%	\$487	
13	EFD	eFUNDS	1.2	8	6.7%	\$0.37	13%	\$880	
14	WNC	Wabash National	0.8	4	16.7%	\$1.32	11%	\$597	
15	CTR	Cato	0.9	Less than 1	2.4%	\$0.67	11%	\$436	
16	FNLY*	Finlay Enterprises	0.3	Less than 1	0.1%	\$0.81	11%	\$112	
17	BHS	Brookfield Homes	0.8	3	2.2%	\$3.88	10%	\$1,539	
18	HSII	Heidrick & Struggles International	1.0	12	37.8%	\$1.13	9%	\$568	
19	RHB*	RehabCare Group	1.0	12	2.1%	\$0.53	9%	\$380	
20	PLFE*	Presidential Life	0.7	5	8.8%	\$1.07	9%	\$541	
	SPX	S&P 500	1.6	23	0.9%	\$0.15	0%		

* Denotes stocks that have not appeared on the Most Attractive list within the last 3 months. See Appendix for details.

Sources: New Constructs, LLC

Appendix 1 – Additions/Deletions from Lists

Most Attractive Large and Mid Cap Stocks

Additions:

USG – Company moved from Small Cap to Large Cap List

ALV – Most recent annual report reflected higher Free Cash Flow Yield and valuation stayed the same.

BSC – Valuation fell as price decreased by 3% from July 6th.

Deletions:

MEL – Valuation rose as price appreciated by 7% from July 6th.

TSN – Valuation rose as price appreciated by 4% from July 6th.

VPI – Valuation rose as price appreciated by 10% from July 6th.

Most Attractive Small Cap Stocks

Additions:

BHO – Valuation fell as price decreased by 10% from July 6th.

FNLY – Recently added to coverage universe.

RHB – Valuation fell as price decreased by 13% from July 6th.

PLFE – Company ranked 21 in July and rose in rank after the departure of companies listed below.

Deletions:

DITC – Valuation rose as price appreciated by 19% from July 6th.

INTL – Valuation rose as price appreciated by 31% from July 6th.

STRT – Valuation rose as price appreciated by 20% from July 6th.

BDY – Filed 10K-NT, delaying report of new financial data. Current data has exceeded the data age maximum of 1 year.

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