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THE TRADER | SATURDAY, MAY 26, 2012

See page 2 - where the part on Delta begins

S&P Up 1.7%, as Stocks End Three-Week Skid

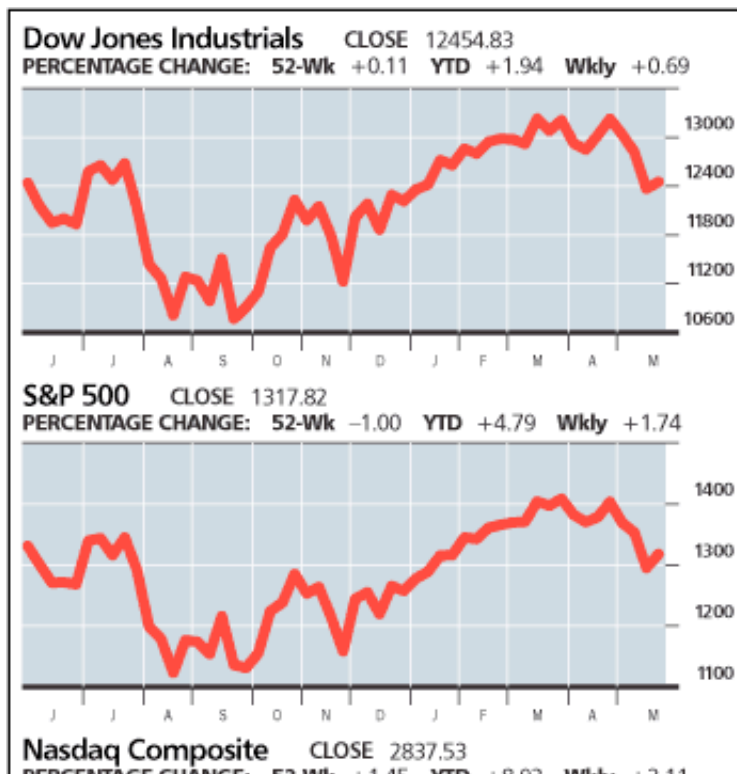
By VITO J. RACANELLI

The Dow rises 0.7%; Nasdaq, 2.1%. A huge pension funding gap at Delta. Why LSI still looks like a buy.

Vital Signs

Summer's coming, and last week's rising market was a welcome respite after three weeks of declining stock prices. But investors probably shouldn't get too comfortable.

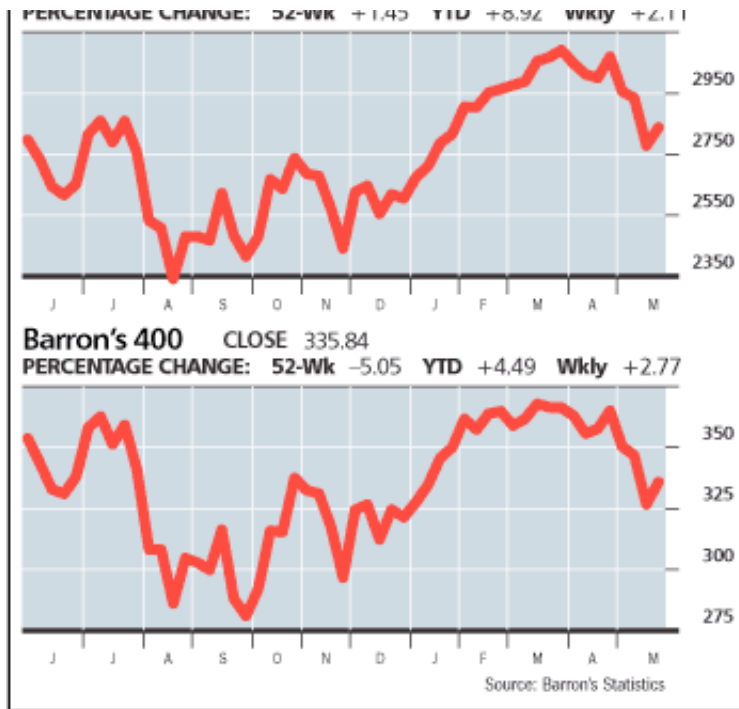
Though Wednesday's reversal was technically impressive—the Dow was down almost 200 points early in the day before recovering to finish higher—serious damage has been done to market psychology since the first quarter ended.



Investors are on edge, worried day to day about world issues like European sovereign debt and Chinese growth, says Doreen Mogavero, CEO of Mogavero & Co. Traders are closing each day with neutral positions, she adds.

That's not the sign of a market about to move sustainably higher. Moreover, when U.S. stocks rallied in the afternoons last week, the buying influx wasn't particularly strong, and didn't inspire confidence, Mogavero notes. Market participants are very divided, she adds.

Not only was trading volume low—we're used to that—but the rebounds often



came mainly in the afternoon when European markets were closed and conveniently in the absence of bad news from the troubled continent.

"Markets are being held hostage to a deteriorating situation in Europe... waiting for any sign of a policy move that will support equities," observes Quincy Krosby, Prudential Financial's chief market strategist. Stocks will struggle until the policy moves come, she adds.

As has been happening in most rallies this year, small stocks outpaced the big. The Dow rose 0.7%, or 86 points, to 13,454.83 last week, but it's been down

on 15 of the past 18 trading days. The Standard and Poor's 500 tacked on 23 points, or 1.7%, to 1317.82, and the Nasdaq Composite gained 59 points, or 2.1%, to 2837.53. The Russell 2000 small-cap index added 19, or 2.6%, to 766.41.

Even if the European Union again rescues Greece, it's hard to imagine a magic bullet in any scenario. Back home, financials remain the sector that worries investors. The first quarter saw a tremendous rally when the group rose. That upward impetus has disappeared, a savvy trader notes.

Indeed, giant and important banks like **Citigroup** (ticker: C) and **Bank of America** (BAC) are down about 50% from their 2011 highs, while even the well-regarded **JPMorgan Chase** (JPM) is off 30%. The trader asks: How does the broad market do well without a substantial improvement in those stocks?

Good question. Enjoy the Memorial Day weekend, but keep one eye on the waves and the other on the headlines.

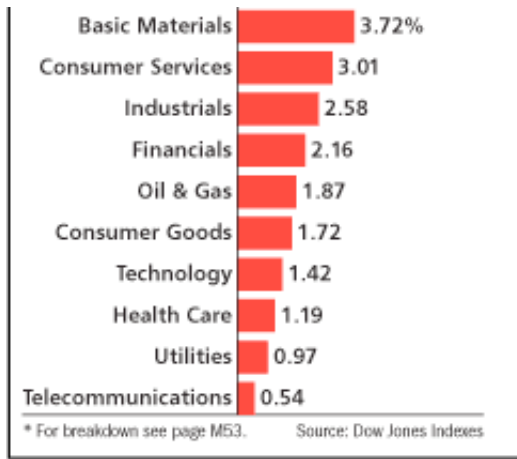
THINGS ARE GOING WELL in the airline patch. Fuel costs fell 4% in April, a month that showed continued good load factors and revenue growth. The summer looks promising, and Delta, as the biggest airline, should reap nice rewards.

Its stock (DAL) has outperformed the market this year, up 39% versus 5% for the S&P 500. It closed Friday at 11.37, up a dime. Delta shares trade at just five times 2012 consensus earnings estimates of \$2.28 per share. Seems cheap, but as an airline Delta bears the cyclical taint.

Industry Action

Performance of DJ U.S. Ind, ranked by wkly % chg. *

More important, despite the sunny skies now, anyone tempted to buy this stock should consider a vital non-



operational concern often given short shrift on Wall Street: **pension plans. Delta's is hugely underfunded.**

Companies address the pension problem once a year in their annual report and then it's usually forgotten. The large size of Delta's pension hole, compared to the airline's stock-market value, however, won't be ignored in the next industry downturn. As of Dec. 31, the deficit in Delta's defined-benefit pension plan and other post-retirement obligations was \$14.1 billion, up from \$11.4 billion in 2010. Over the long term, that shortfall must be

made up—either through better asset returns or cash injections. Delta's net debt position of \$10 billion is more than its \$9.6 billion market cap.

David Trainer, president of research outfit New Constructs, says that Delta's stock might come under pressure as investors realize the company is using "relatively aggressive" accounting for its retiree obligations.

For example, he says, Delta boosted 2011 earnings by increasing its expected return on plan assets (EROPA) to 8.93% in 2011 from 8.82% in 2010. Assuming a higher expected rate lowers the amount a company must pay into its plan. Had Delta instead lowered its expected return one percentage point, some \$78 million, or 9%, of its 2011 net income would have been wiped out, says Trainer.

Out of more than 1,000 companies with pensions, Trainer says 98% have a lower EROPA rate than Delta. And it is rising while more than 90% of companies have flat or falling return assumptions because of low interest rates and poor stock-market returns.

Given what's happened in stock and bond markets over the past 12 years, **Delta's almost 9% expected return seems far too bullish.** As Trainer says, the plan's assets would all have to be in riskier equities to generate such a lofty return. He estimates that **actual plan returns since Delta emerged from bankruptcy in 2007 at 1.5%-to-3.8%.** (More is available at blog.newconstructs.com. Trainer's Novo hedge fund is short Delta stock.)

Delta contributed nearly \$600 million last year into the pension plan and has said in a conference call that it will have to pump in \$400 million this year.

That might not seem to be much for an airline expected to have \$4.6 billion in earnings before interest, taxes, depreciation and amortization this year. And Delta could get lucky: Sharply rising stock prices and higher interest rates would help close the funding gap by raising asset prices and returns, and push up the discount rate used in the pension planning. But jet fuel has a funny way of spiking when you least expect it, and an airline industry downturn will inevitably come. When it does, the often overlooked pension issue will come back to haunt investors who chose to ignore it. The airline declined repeated requests for comment.

Delta's pension deficit isn't a problem until it is.

LSI 'S STOCK HAS FALLEN 13% since *Barron's* wrote favorably about it last month ("**The Little Chip Maker That Could**," April 23). The company is a leading designer of semiconductors and software for hard drives and flash drives, and for directing the flow of data in networking equipment.

The broad market has dropped sharply from highs on fears about global growth. And investors fear that higher inventories of hard-disk drives will hurt HDD makers like LSI. But the company has its hands in many technology pots. The explosion of storage demand long-term still makes this stock (LSI) undervalued.

One thing we didn't write about last month is the possibility that LSI might begin paying a dividend. In an interview with *Barron's*, CEO Abhijit Talwalkar hinted at the possibility that a payout soon could be addressed by the board.

LSI has effectively no debt and plenty of cash—about \$623 million—so why not take on some more debt to help returns on equity? Talwalkar's answer: In the current "risk on, risk off" market, in which stocks get whipsawed, "I'd rather be in a low debt position."

Moreover, LSI has been buying back stock, about \$500 million worth in the past couple of years, and that will likely continue.

What about mergers and acquisitions? He replied that any near-term deals would be of the bolt-on variety, rather than large.

Well, how about a dividend? "For the last three to four years, that made no sense, as LSI was cleaning up issues," like getting out of the external hard drive business and entering the flash drive arena, said Talwalkar. "Now, however, we need to think about that."

Investors should stay tuned.

ACCORDING TO AN OHIO STATE University study done in 2007, founder-led firms tend to invest more in research and development, command higher valuations than peers, and outperform them in the long run.

They also seem to attract a lot of shorts.

No Respect

Among firms run by founders, Chesapeake Energy, Netflix and salesforce.com are among short-sellers' favorite targets. But shorting is lower than average at Oracle, Starbucks and Amazon.

Company/Ticker	Founder	Short Interest As
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Data Explorer analyst Simon Colvin has found higher-than-average shorting of the stocks of founder-run companies in both the Russell 3000 and S&P 500 indexes. The 296 Russell 3000 firms still run by their originators have 17% more of their shares on loan than the overall market average. The phenomenon is more pronounced in the S&P 500, where there are fewer

		% of Shares Outstanding	
Chesapeake Energy/CHK	Aubrey K. McClendon	14.7%	pronounced in the S&P 500, where there are fewer such firms. There, the founder-led firms have 23% more shares sold short than the index average.
salesforce.com/CRM	Marc Benioff	9.7	In a broad sense, this is probably generalized worry about the common problems posed in founder firms, such as fears of capital being wasted on empire building and white elephants, Colvin says.
Expedia/EXPE	Stephen Kaufer	9.2	
Urban Outfitters/URBN	Richard A. Hayne	7.6	
Netflix/NFLX	Reed Hastings	7.5	A closer look, however, at the 25 S&P 500 members still led by their founders shows, he adds, that shorting is mainly skewed to nine firms. (See table.)
Cerner/CERN	Neal L. Patterson	6.5	
Omnicom Group/OMC	Jonathan Nelson	5.5	This suggests, according to Colvin, that the shorts are making distinctions among the founders and that perhaps the shorts fear some more than others.
TripAdvisor/TRIP	Stephen Kaufer	5.3	
VeriSign/VRSN	D. James Bidzos	4.5	
S&P 500		2.9	It's perhaps no surprise that investors are heavily short troubled Chesapeake Energy (CHK), which is under pressure for governance concerns and potential conflicts of interest with CEO and founder Aubrey McClendon. Netflix's (NFLX) Reed Hastings and salesforce.com's (CRM) Marc Benioff also attract heavy short interest.

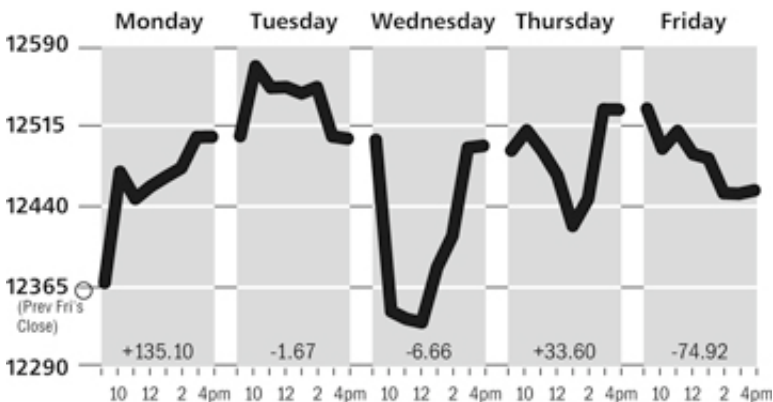
Source: Data Explorers

Which founder companies do the shorts fear? They're Larry Ellison's **Oracle** (ORCL), Howard Shultz's **Starbucks** (SBUX) and Jeff Bezos' **Amazon.com** (AMZN). Each has less than 1% of its shares on loan.

Breaking a Skid

After three losing weeks, the Dow Jones Industrial Average rose 0.7% last week. Home Depot and Wal-Mart Stores jumped 5%, but Pfizer fell 2%.

FIVE-DAY DOW COMPOSITE



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