THE TRADER

Defying Iraqi Risk, Dow, S&P Set New Records

Investors buy in to Fed Chair Yellen's dovish rate outlook and inflation explanations while sidestepping geopolitics for now.

By VITO J. RACANELLI
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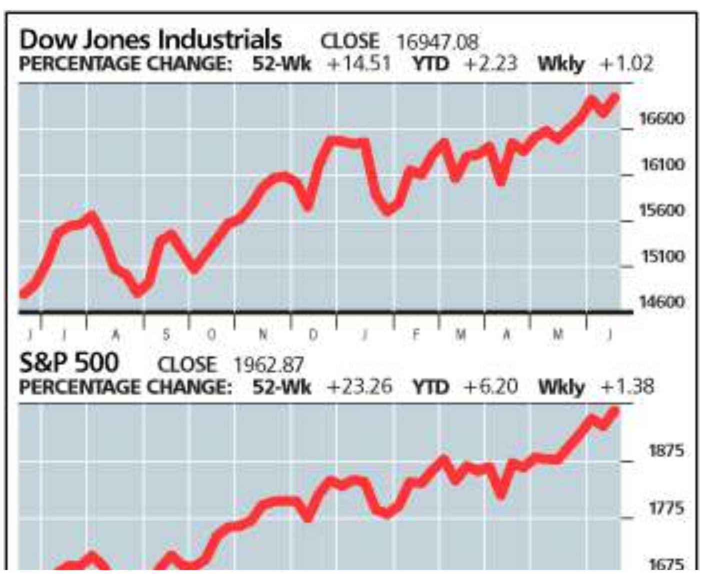
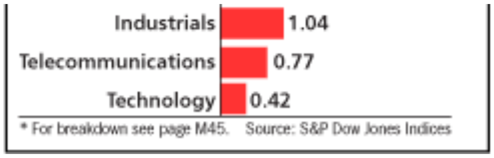
Vital Signs

Stocks racked up another set of gains last week, as both the Dow Jones Industrial Average and Standard & Poor's 500 index notched new all-time highs on Friday. In contrast to the response to the Ukrainian political and military crisis, investors have so far paid little attention to the fighting in Iraq and resulting higher oil prices. Small-caps outperformed large-caps, suggesting the risk-on trade was in full swing.



With relatively few economic news reports released, most of the action took place on Wednesday, when the Federal Open Market Committee meeting was held. In the press conference afterward, Federal Reserve Chair Janet Yellen tamped down inflation worries, and her comments suggested the rise in interest rates that nearly all investors are expecting will take place later rather than sooner.

Last week, the Dow rose 171



actual guidance reduction wasn't much; EPS are still expected to grow 12%.

Express Scripts will continue to benefit from all the long-term tail winds we've noted in previous items about the company: good growth in generic drugs in response to brand drug inflation; an aging U.S. population; health-care reform, expanding health coverage, and ongoing drives to reduce drug costs.

In particular, its mail and specialty pharma business is high margin and keeps growing well, adds Retzler. The firm has one of the best pharmacy-benefit management systems around, with all clients on a single information platform, making it easier to, for example, update for new rules, regulations, and formulas, he adds.

It doesn't hurt that Express Scripps happens to be a well-managed company with a good balance sheet, too, with $9.3 billion in net debt, and a debt to equity ratio of about 40%.

Here's a company getting good growth at a time when it seems only Internet stocks are showing that, Retzler notes. Mr. Market's sell-off has rendered Express Scripts valuation reasonable again, he says. By various metrics, the stock is significantly cheaper than its long-term history. The price/earnings ratio of 16 is below the median of 22, and attractive given the company's 2014 EPS guidance.

Express Scripts is a solid business that should recover if the bull market continues and should also prove defensive should a bear market unexpectedly appear. The new worries should recede over the next two to four quarters. As that happens, a 10% rise from here over the next 12 months seems, well, fair.

PetSmart on Sale

In like manner, investors have taken a big bite out of PetSmart (PETM) shares for reasons that might turn out to be shortsighted. Like the pharmacy-benefits manager, the big retailer of pet foods and services offers long-term attractions that should make bargain hunters sit up and take notice.

Last month, the company reduced its EPS outlook for the fiscal year ending on Jan. 31, 2015, to $4.29 to $4.39 from $4.42 to $4.54. The sales-growth forecast was downgraded to "low single digit" from 4% to 6%, and same-store sales to flat from 2% to 4% growth. Pet-Smart blamed a challenging consumer environment and a competitive marketplace.

Since the announcement, the stock is off 10%, sparked by fears PetSmart will be savaged by the Internet, the way Best Buy (BBY) and Staples (SPLS) have been. It's down 20% this year, sharply underperforming.

As with most retailers, the Internet poses a threat, but PetSmart isn't Best Buy or Staples, says Sam McBride, an analyst at New Constructs, an independent stock-research outfit.

It offers both products and pet services like grooming, boarding, training, and veterinarian care that online retailers can't match, he points out. Investors also miss that pet owners have an emotional connection to their pets that is a lot stronger than it is to an electronic device, he says.

Pets have been a big business in the U.S. for a long time—it's roughly a $37 billion industry—and pet-food sales are growing at a nice 4% to 5% annual clip. More importantly, perhaps, many American pet owners are upping their level of care.

McBride says PetSmart is taking advantage of spending by "pet parents"—that is, a growing component of owners who treat their pets like children. These pet owners are more likely to pay a premium for personalized service and utilize PetSmart's in-store services. Pet-food makers are coming up with customized and organic foods for pets, which are higher-margin.

Admittedly, services are a smaller part of sales, at 12%, but they help drive overall traffic. PetSmart earns a 15% return on invested capital, up steadily from 9% in fiscal 2010, says McBride. That means it's pushing more sales and profits through the firm's assets. Average invested capital turns, he adds, have improved 36%, to $2.07 from $1.52, a fancy way of saying that for every dollar invested PetSmart gets $2.07 in sales.

The $5.8 billion market-cap firm sports a decade of double-digit EPS growth and solid sales increases, which suggest it has a sustainable business edge. While the Internet threat should not be ignored, it's not a new concern. It seems more likely that PetSmart had a tough quarter. A look at its results over the years shows quarterly periods where same-store sales growth stalled or even fell, only to recover later.

PetSmart's moat, says the analyst, comes from the variety of products it carries and the value-added services it offers, McBride says. It stocks premium dog and cat foods, many of which are not available at supermarkets, warehouse clubs, or mass merchandisers.

And competitors like Amazon's Wag.com, for example, should have significant logistical and pricing benefits but can't compete with the in-store services PetSmart provides. McBride compared PetSmart's top 10 selling dog foods at the company's own retail Website to Wag.com and found the latter is either priced higher or doesn't carry the product.

PetSmart's shares are now the cheapest they've been in some time, compared with both its history and the S&P 500 index multiple. At a forward price/earnings ratio of 13 times, the shares trade at a big discount to the median 18 multiple.

One peccadillo is that the company's dividend yield is below 2%, but PetSmart has raised it steadily. PetSmart should get its groove back, and when it does shareholders will likely be purring with happiness.