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# Beware These 'Toxic' Stocks

Certain shares may appear enticing now but they could poison your portfolio later. On the list: Valero, Williams-Sonoma, and Winnebago

by Gene Marcial

Bullish noises for the market abound. Fed Chairman Ben Bernanke makes it clear that he's prepared to pull out all the stops to prevent economic collapse, and Treasury Secretary Henry Paulson is talking up broad investor-friendly reforms for market regulators. And, while still behind the fiscal curve, Congress is finally recognizing that emergency measures are needed to help alleviate homeowners' pain and to help prevent a financial catastrophe.

With the close of a dismal first quarter, there hangs a faint whiff of optimism in the air over Wall Street. But a warning to investors ready to plunge into the market: Beware of land mines. Even if you think you know perfectly well which stocks are safe, the current market remains a beehive of hazards. Watch out, first of all, for "toxic" stocks that may appear enticing now, but could poison your portfolio at this critical stage of the market.

In investing, spotting stocks that could implode is as important as picking the potential winners. With the market as volatile as it is, it would be wise for investors to expect a surprise that could swing stocks skyward, in which case droves of investors would flood in, enthused to buy. But an equally compelling case can be made that the market will deliver a negative surprise, ensuring further chaos. Either way, it is essential to guard against "time-bomb" stocks, especially now when the market is displaying signs that the bull is ready to ram the gates.

## NEXT MOVE WILL TEST AUGUST '07 HIGHS

"Although the absolute bottom can't be determined, the amplification of volatility, panic, and fear has built a base (floor) in the major market indexes," says Eric Parnes, managing director of Technomart Investment Advisors. The next move should be a "sustained rally that will challenge the highs the market established in August, 2007," predicts Parnes, who is also editor of the market newsletter *Shortex*.

Certainly there are stocks to chase now, but emotion should be the last to dictate which stocks to buy. One factor that's important to consider in ferreting out potential winners, as well as potential toxic stocks: plain old fundamentals.

Parnes argues that given such a parameter, investors should flee from, among others, Winnebago Industries (WGO), Valero (VLO), and Williams-Sonoma (WSM). Winnebago, the Iowa-based maker of self-contained recreation vehicles used primarily for leisure activities, is suffering from an earnings squeeze, says Parnes. It reported second-quarter earnings of 9¢ a share, a 67% drop from analysts' expectations of 21¢. What's crimping earnings are high inventory, a declining backlog, rising gasoline prices, and high borrowing costs. Now at $17 a share, just above its 52-week low, Parnes expects Winnebago to drop to $12.

Valero, the largest oil refiner in North America, is under pressure because of expectations that margins will turn sharply lower. The stock, now at $50 a share, could retest its previous low of $44, says Parnes. And Williams-Sonoma, a specialty retailer of upscale products for the home, owns Pottery Barn, West Elm, and Williams-Sonoma Homes. The company is among those suffering from the decline in consumer spending as a result of the housing slump, says Parnes, who expects the stock, now at $26 a share, to see $14.

### TIME TO DUMP DEPARTMENT STORES

Some of the department-store stocks should definitely scare away investors, says Georges Yared, president of Yared Investment Research, among them Macy's (M), which operates more than 800 Macy's and Bloomingdale's stores, and Dillard's (DDS). Now at $23, Macy's is apt to fall to $18 as Yared expects 2009 earnings to drop to $1.70 a share.

Standard & Poor's analyst Jason Asaeda, who also has a sell recommendation on Macy's, expects 2008 earnings of $2.01 a share. The retailer earned $1.80 per share in 2007. Dillard's, which operates 330 department stores mainly in the South and the Midwest, is now at $22 a share. Yared expects it to tumble to 15. Dillard's earned 69¢ a share in fiscal 2008. Yared figures it will report a loss in fiscal 2009. S&P's Asaeda, who also rates Dillard's a sell, expects that accounting for likely share buybacks, Dillard's could see operating earnings of 50¢ a share.

### NEW YORK CITY REITS STILL A BUY

Shares of real estate investment trusts, once market highfliers, could also prove toxic. Obviously, the protracted housing slump is dampening the outlook for the group. "We are maintaining our cautious view on REITs," says Goldman Sachs (GS) analyst Jonathan Habermann in a report on the sector. "We believe REITs will underperform the broader market in 2008, given adverse capital-markets conditions, and deteriorating real estate fundamentals," he warns.

There are some REITs, of course, that he favors, such as those involved in regional shopping malls and offices in New York City. But he is down on such companies as Avalonbay Communities (AVB) and Camden Property Trust (CPT), both of which he rates a sell. Avalonbay, now at $104 a share, is $30 off its 52-week high, and Camden, now at $54 a share, is off from a May high just below $78. S&P analyst Royal Shepard, who rates Camden a sell, has a 12-month price target of $43. Shepard rates Avalonbay a hold, with a price target of $96.

Homebuilders, severely hammered as a group, have attracted bargain hunters. But Steven Roge, investment manager at R.W. Rogé, raises the red flag on Hovnanian Enterprises (HOV), which builds single-family homes and attached condominiums and townhouses nationwide. He hasn't shorted the stock but it is one, he says, that deserves close scrutiny because its debt of $2.25 billion dwarfs its market capitalization of $755 million. Kenneth Leon of Standard & Poor's, which rates Hovnanian a hold, has a 12-month price target of $9.50. Now at $12 a share, the stock dived from $27 in May, 2007. In early January, 2008, the stock hit a low of $4.25 a share. The homebuilder posted a loss of $2.80 from continuing operations in 2007 ended Oct. 31.

### IS FOUNDATION COAL HEADING FOR A FALL?

David Trainer of independent research company New Constructs warns that Duke Realty (DRE), a REIT whose stock has skidded from $45 in May, 2007, to $24, should still be avoided. Duke owns interests in industrial, office, and retail proprties in the Midwest and Southeast. Trainer says that its reported profits "are positive and rising while the true underlying cash flows are negative and declining." Net income was supposed to have risen by over $72 million last year "while our analysis shows its true cash profits fell by $31 million," says Trainer. Although the stock has taken some lumps, "we think it has plenty farther to fall," Trainer cautions.

Another stock Trainer describes as a "bomb waiting to explode" is Foundation Coal Holdings (FCL), which produces coal in Northern and Central Appalachia, Wyoming, and Illinois. Its stock has shot up to $54 from $30 on Aug. 16, 2007. Despite such "nosebleed valuation," the stock should scare off investors because its current market valuation implies the Maryland company's profits will rise nearly 1,200%, Trainer says. Commodities have been on the rise, he observes, but "I don't think we are going to see the price of coal go up enough to justify Foundation Coal's valuation." Its earnings from continuing operations have dropped from $1.10 a share in 2006 to 88¢ in 2007, according to data from Bloomberg.

To be sure, there are plenty more such toxic stocks in various industries. But these are a good place to start for investors who not only wish to avoid danger but who may want to profit from short-selling. As the saying goes, forewarned is forearmed.

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