

June 17, 2008

He Seemed like Such a Harmless Boy

Believe it or not, we are just two weeks away from the end of the second quarter and the start of another earnings season. While every earnings season is fraught with opportunities and risks, reporting seasons occurring in the midst of a weakening economy have historically been more worrisome, because the headwinds are typically stronger and investors are less forgiving.

One of the most important lessons we have learned from past earnings reporting seasons is that the biggest downside surprises are not necessarily always reported by the companies one would expect. The companies that seem to pose the greatest danger are those that have managed to “fly below the radar screen” for most of the past quarter. When negative earnings are announced or forward earnings guidance is reduced, the typical reaction is significant because the market did not see it coming and had not already discounted a margin of safety into the share price.

Because of their ability to stay out of the headlines, these companies are particularly difficult to find. However, there are several characteristics that have been helpful in identifying these companies in the past:

- 1. Previous Earnings Miss Or Negative Guidance:** As with cockroaches, rarely does one find just one earnings disappointment. Companies that have recently missed earnings or issued negative forward guidance often repeat the process several quarters in a row before regaining their footing.
- 2. Lackluster Performance Relative To The Rest Of The Market:** To fly below the radar screen, a company has to register performance that does not cause investors to take notice. With energy prices soaring and financial stocks plummeting as they did this past quarter, most investor attention has been drawn away from all but the most urgent issues in their portfolio. For this reason, we expect the earnings season to be particularly dangerous this time around.
- 3. Significant Resistance Ahead:** Historically, the 200-day moving average has represented one of the more significant areas of technical resistance for stocks. We view companies whose share prices have remained below their 200-day average during the second quarter despite the market's strength as particularly vulnerable.

Where To Be Wary: The companies listed below are widely held and exhibit all three of the characteristics listed above. Entering earnings season, we would watch these positions closely and look to employ risk management (trimming or eliminating) if these stocks break below the areas of technical support listed (some companies have already broken support levels where noted):

Abbott Labs (ABT-N-\$54.33) Support: \$50	Aetna (AET-N-\$44.39) Support: Broken	Amgen (AMGN-O-\$43.99) Support: \$41.50	Allstate (ALL-N-\$49.85) Support: \$48.50
American Express (AXP-N-\$44.68) Support: Broken	Bristol Myers (BMY-N-\$20.06) Support: Broken	eBay (EBAY-O-\$28.65) Support: Broken	Fannie Mae (FNM-N-\$25.60) Support: Broken
Home Depot (HD-N-\$27.50) Support: \$25.50	Hartford (HIG-N-\$72.32) Support: \$70.00	Travelers (TRV-N-\$48.20) Support: \$46.00	Time Warner (TWX-N-\$15.19) Support: \$14.00
Intel (INTC-O-\$22.86) Support: \$21.75	Kimberly Clark (KMB-N-\$61.99) Support: Broken	Lowes (LOW-N-\$24.05) Support: \$22.50	MetLife (MET-N-\$58.94) Support: \$55.00
Motorola (MOT-N-\$9.12) Support: \$8.75			

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