

# welling@weeden

<http://welling.weeden.com>

VOLUME 7

ISSUE 22

DECEMBER 15, 2005

**INSIDE**

**Listening In**  
Einhorn Makes His  
Bull Case And  
Cooperman  
Chimes In With  
Enough "Cheap"  
Stock Picks To  
Deck Many A Hall  
For The New Year

PAGE 1

**Talk Back**

Photo Snafu

PAGE 8 & WEB

**Listening In, Too**  
Marc Faber Vs.  
Louis-Vincent Gave  
Brave New World  
Of Platform Firms  
Or Coming Bust  
From Credit Binge?

**Guest Perspectives**  
William Hester  
A Downer In '06?

Paul Brodsky  
Economic Mystery

Bob Hoye  
Copper Peaking

**Acute Observations**

ALL ON WEBSITE

listeningin

## Stocking Stuffers

Cooperman And Einhorn Survey The Outlook And Find Plenty To Buy

**Leon Cooperman.** *Need I say more? The powerful bull market wave that Lee caught when he left Goldman to start Omega early in the last decade is no more. But the legendary analyst, now in league with fellow Goldman alum Steve Einhorn, continues to drive Omega Advisors to performance heights that leave most rival hedge fund managers green with envy. I checked in with the dynamic duo a couple of weeks back for a reading on what's in store in 2006. The good news: while worries abound, Lee and Steve see them having little impact on the economy or stocks. In fact, let's just say it: Finding numerous big caps infinitely buyable, they're doing just that. For what and why, keep reading.*  
**KMW**

Steve and I have this very old-fashioned notion of accountability, so we gave one of our associate analysts the responsibility of reading the last interview we did with you, which was published on March 12, 2004. Here's his memo: "At that time the S&P was at 1112, about where it started the year. We discussed

many of the structural imbalances, the economy, etc. The bottom line, however, was that S&P would trade in the range of 1000-1200 in '04. The actual range was 1045-1212—not bad. Estimated S&P in '04 deliver a price return

of about 7-9%. The actual price gain was 8.9%—not bad.

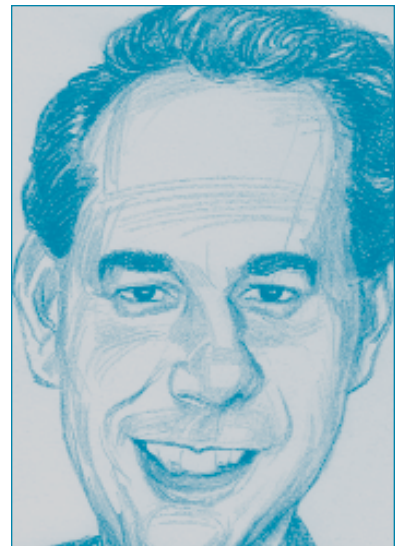
**Indeed.**

We expected the economy to be fine and inflation tame. This also was on the mark. The stock picks are up better than 45% on average, versus the S&P, which is up 9.7%. In other words, we recommended 8 stocks, the average gain in those 8 was 47.8%. If you add in dividends, the total return was 51.1%. The S&P, price only, was up 9.7%, including dividends, it was up 13%.

**Not bad, Lee. But that's history. What are you up to now?**

The way we have divided responsibilities at Omega—much to my benefit—is that Steve spends full-time worrying about the economy, monetary policy, market valuation; I only spend about 10% of my time doing that, and mostly rely on his work, which has been excellent. I spend my time talking to companies—beating up managements to try to get

them to do things that are in the interests of our investors. But I have to tell you, we would call ourselves moderately optimistic about the market. Steve can give you a lot more detail, but the economy is fine. Real GDP growth ought to move



**RESEARCH  
DISCLOSURES** PAGE 8

**Kathryn M. Welling**  
Editor and Publisher

**Jean M. Galvin**  
Business Manager and Webmaster

**Karin-Marie Fitzpatrick**  
Editorial Assistant

**Alexander Isley Inc.**  
Graphic Design

Weeden Securities Corp.  
Board of Directors

**Donald E. Weeden**

**Barry J. Small**

**Robert A. Cervoni**

**Timothy McDonald**

**Robert DeMichele**

**Daniel V. Panker**

**Richard Sharp**

**Richard Schmaltz**

**Craig Hetherington**

**Christopher Mahler**

**Todd Trimmer**

welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP.

Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830.

Telephone: (203) 861-9814

Fax: (203) 618-1752

Email: welling@weedenco.com  
jean\_galvin@weedenco.com

First-class postage is paid at Stamford, CT

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or part of this publication or its contents by any means. The Copyright

Act imposes liability of up to \$150,000 per issue for such infringement. welling@weeden does not license or authorize reproduction by clients or anyone else. However, multiple copies are available to clients upon request and limited reprint arrangements are available. Copyright 2005, K.M. Welling and Weeden & Co. LP. All rights reserved.

**Ann Field**  
**Victor Juhasz**

Page 1 Illustrations

ahead somewhere in the area of 3%. Corporate profits are decent. Valuation—the word we like to use is “undemanding.” The S&P is at about 16 times ’05, 15 times ’06 estimates, which is reasonable. Historically, when inflation has ranged between 1% and 3%, the S&P multiple has been in excess of 17 times, and I would venture a guess that in times past, when the S&P multiple was where it is now, 15 times next year’s earnings, the 10-year government bond was nowhere near 4.5%. In other words, the interest rate level would have been higher than it is presently, and you still would have had multiples in line with or higher than they are presently. Also, we would point to this huge pool of private equity money as a plus for the market. Something like \$400 billion has been raised by private equity guys, and they look to use leverage of about 4:1.

So they want to buy something that approaches \$1.6 trillion worth of companies. Of course, they could be public or private, domestic or global, but that’s *not* an consequential amount of money. In addition, there is about a trillion dollars in the hands of hedge funds. If you arbitrarily

figure that 10% of that should wind up going the activist route, and you multiply that by four with leverage, there will be another \$400 billion looking to buy. What’s more, we think stocks are cheap relative to bonds,

#### What’s your calculus there?

Well, if you are a businessman and you have a choice of buying some stocks at 10-11-12-13 times earnings, and yielding maybe on average 2%, or buying some government bond yielding 4.5%, I for one would rather take a chance on the equities, particularly given what I see going on with fiscal policy and underlying inflationary pressures. Lastly, there are no real effective alternatives of consequence. Those are the kinds of things that keep us engaged.

Though I probably should add, most importantly, that we’re finding lots of stocks that look cheap to us; that we are comfortable owning.

#### Yet you don’t sound like you’re pounding the table here, Lee.

Well, the negatives are still the same negatives that we talked about when we spoke last. We have a relatively unbalanced economy in the sense that in the last four or five years, the consumer has taken out—and spent—an enormous amount of liquidity from the appreciation of their homes. Which in part explains the very low savings rate. But the upward movement of rates has ended that game. Home prices have crested. A collapse, like some of the Cassandra’s are talking about, probably is *not* in store. But certainly the price increases have crested.

We now have the problem of high energy costs that the consumer is having to live with. It’s a real factor. And we have this loss of competitiveness of U.S. workers. I thought it was very interesting when **Steve Miller**, the fellow who took over and then quickly put **Delphi** into bankruptcy, sent a letter to Delphi’s labor force. It was a very compassionate and very understanding letter, but its essence was, “You guys are hard-working, you’re terrific people, but you have to take a 70% cut in wages to be competitive globally.” The final concern we have is that the Fed, while not hostile, isn’t friendly, either. When I grew up in this business, there was that old rule about “three steps and a stumble.” Well, now we’ve had, what? 12 [Tuesday’s made 13] Fed tightenings?

#### Quite a few.

That’s right. And everything we read tells us three more are baked in the cake, two more in the Greenspan era, and then Bernanke will do one just to show that he is his own man, so to speak.

#### While not doing anything too precipitate that might be construed as breaking from the maestro’s legacy.

Right. Nonetheless, 15 tightenings are an issue that the market has to live with. So right now, I’d say that the stock market is undervalued relative to the 10-year bonds, given the outlook for profits. That’s my big picture, but let me turn you over to Steve to fill it in the economic outlook.

#### Then I’ll ask Steve, aren’t you at all concerned about an inverted yield curve?

**Steve:** Not really. The worry that investors have about a flat or inverted yield curve causing a marked slowdown in the economy, or even a recession, is based upon a mechanical application of history. It is certainly the case, historically, that when the yield curve has flattened and/or inverted, there has been a material slowing in economic activity as measured by real GDP growth. However, in every one of those instances, the yield curve was inverting because *both* short *and* long-term interest rates were rising. It was just that short rates were rising *more* than long rates. In this current instance, however, long rates are essentially unchanged, and it’s short rates which are rising and threatening to invert the yield curve.

#### So?

So there has been no brake on the economy owing to a rise in long-term interest rates. Housing, while it is moderating, is certainly still at a very high level in terms of unit demand and price appreciation. Consumer spending, which would be affected by higher long-term interest rates, has held up quite well, remarkably well, when one considers the vari-

**“We are finding a lot of stocks that look cheap to us; that we are comfortable owning.”**

ous hurricanes and energy shocks the economy has witnessed this year. So I think this notion of a flat yield curve becoming a material drag on the economy has not only been wrong, it will continue to be wrong. In that regard, the yield curve has been flattening now for two years—and we have had 10 straight quarters now in which real GDP growth has been 3% or more, which is unprecedented in the last 25 or 30 years.

#### **That many quarters?**

It's not only a long stretch in terms of duration, but the real GDP growth we've been seeing has been very steady, very low-volatility. So the economy is fine. It will grow through 2006.

#### **You see *no* slowing in the New Year, even as consumers get walloped by massive increases in heating bills?**

GDP growth will slow next year from this year's pace of maybe 3.5% real to about 3%, but I don't see anything more material than that. I fully expect the consumer, who will slow this quarter because of jobs lost to the hurricanes, etc., to come back in the first and second quarters of next year. In addition, and most importantly, the economy now is getting a real boost from the manufacturing sector. Capital spending is accelerating, inventory building will accelerate this quarter and next—because inventories were drawn down last quarter. So even with a moderation in housing, even with some slowdown in consumer spending, the offsets of capital spending, inventory building, hurricane reconstruction—all of those should bring about respectable economic growth next year. Slower than this year, certainly, but still about 3%.

#### **You're actually expecting a *pickup* in capital spending projects in *this* country, instead of more outsourcing?**

Companies don't tend to break it out that finely, but real capital spending plans are rising at close to a double-digit growth rate. That, together with low inventories and the need to rebuild after the hurricanes, should be sufficient to underpin 3% GDP growth. That's a slowing, clearly, from 2004's 4.4%; and with this year probably coming in at 3.5%. But it is a very moderate slowdown. It should still provide an underpinning for higher, not lower, share prices.

#### **How so?**

Because that pace of economic growth will bring decent earnings growth of 7-10% next year. Meanwhile, dividend growth should be double-digit again. It will be 15% this year. It will be 10-12% next year. There is a massive amount of cash on the balance sheets of the corporate sector. Cash as a percentage of assets in the corporate sector today is double its long-term average. That cash, plus free cash flow, is being used to generate double-digit dividend increases, to do big share buybacks, to fund big merger and acquisition activity, and to deleverage, all of which *have* to be to the benefit of stock prices, you would think.

#### **So you're bullish, basically, because the economy should be okay and corporations are loaded to the gills with cash?**

Yes, but there's also a third underpinning for the market as we see it, which is inflation. For all the talk about energy prices poisoning the inflation outlook, *core* producer prices and *core* consumer prices have actually been *decelerating* year-to-date. None of the energy price explosion has been reflected in any of the non-energy price indices, which is a *terrific accomplishment* in terms of the U.S. economy. So inflation is tame, and likely to stay tame. The Fed probably has three [now two] more tightenings in front of it, but the bulk of the tightening is over. So that constraint to the market



should be lifted sometime in early to mid-2006. And all of that says to me that the natural direction of share prices should be higher.

#### **The core measure doesn't count them, but higher energy costs are a fact of life. If companies aren't passing them through to consumers, they're bound to show up in squeezed margins and profits.**

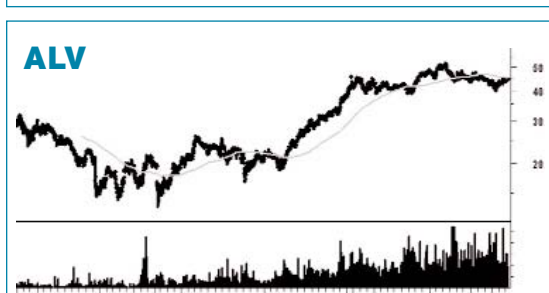
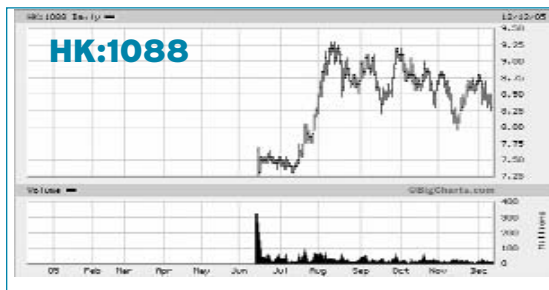
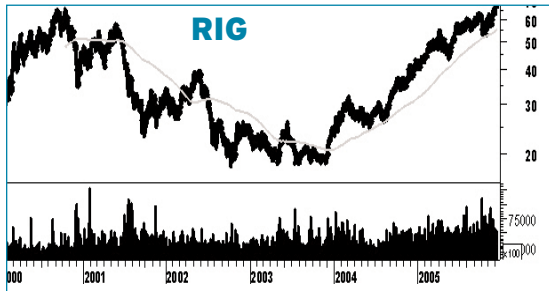
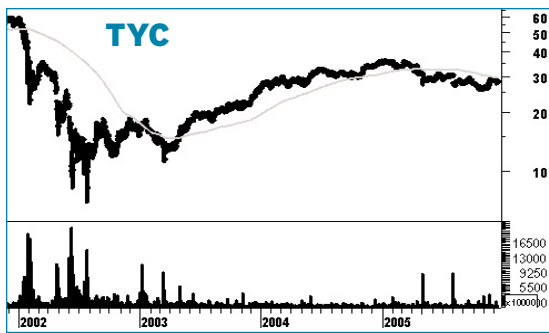
You would naturally expect that, although it is interesting that profit margins have actually held up quite well and profits continued to grow in the third quarter of this year—and likely in the fourth quarter of this year—at a double-digit rate. The reason is that productivity has been well above-trend. That has put a cap on unit labor costs. As you know, labor is two-thirds the costs of the typical company. So even though companies have not been able to pass through higher energy and commodity costs, they have been more than offset (given the size of labor) by well-above-average productivity growth and well-below-average advances in unit labor costs. That is how companies have been able to protect margins and grow profits at a double-digit rate even with higher energy costs.

#### **Rising productivity has been Chairman Greenspan's best friend. What are you expecting from Chairman Bernanke?**

I think what you will get from Chairman Bernanke is exactly what he said in his Congressional testimony. He wants to provide a seamless transition from Mr. Greenspan to himself.

#### **Even if he does want to target inflation.**

Well, Bernanke talks about this issue of inflation targeting, which does differentiate him from Greenspan, who has been opposed to setting a specific inflation target. But Bernanke was very flexible in his discussion of it. He said, "First of all, we won't do anything until there is a consensus within the Federal Reserve that it is the appropriate policy to follow—and that consensus is not there yet. Second, it will not be applied robotically. It will be applied with discretion." The reason for having a specific inflation target at all is that Mr. Bernanke and most others believe that price stability is what fosters economic growth and full employment. So I think any notion that he is robotic and doctrinaire because he was an academic, was removed by his testimony in Congress. Mr. Bernanke evidenced a lot of flexibility in his practice of monetary policy. I think he's a wonderful choice.



**You're not worried about him throwing money from helicopters?**

Oh no, Look, he made that comment in a period when there was a deflationary threat. He was, you know, a bit hyperbolic. But I think he has learned that, coming from a Federal Reserve official, the market doesn't appreciate hyperbole. I doubt very much you'll hear any hyperbolic comments from him going forward. What he was trying to say, basically, was that the deflation threat, which at that moment was consuming the capital markets and business people and consumers, was not as big a threat as they imagined because the Fed could always provide liquidity to the economy to offset deflationary tendencies. But that doesn't mean at all that Mr. Bernanke is an inflation dove, because he's not. The response of the bond market to his testimony was indicative that the bond market now understands that he will be as important an inflation fighter as Greenspan has been.

**You haven't mentioned it, so can I assume you're not worried about unbalanced trade flows and the current account deficit?**

All I can do is describe the latest numbers that have come out as terrific. Flows into the U.S. from foreigners in September, the latest data available, were a record \$102 billion. Year-to-date, on average, they are running \$74 billion per month. Our trade deficit is running about \$60 billion a month. There has been absolutely no difficulty in funding our trade deficit. The best evidence of that is that the dollar is up 15% year-to-date, and that's with a growing trade deficit, which is now about 6.5% of GDP. So there has been no issue at all with respect to funding the trade deficit. My expectation is that it will continue not be an issue. Our trade deficit will come down as the percentage of GDP slowly and naturally as economies outside of the U.S. begin to grow faster, as our consumers slow and as we import less and, eventually, as the dollar comes down. I'm not concerned by it. Interestingly, both Greenspan and Bernanke have recently said they don't see the trade deficit posing a dollar dilemma. It will be resolved slowly over several years. Meanwhile, international flows are terrific and the best evidence that the trade deficit is not the dilemma that the perma-bears have described it as.

**Are you guys taking currency positions these days?**

No. That's not what we do. We more or less hedge our non-U.S. equity exposure. But we're not currency traders per se.

**Omega has had sizeable foreign exposures at times in the past. Now, even U.S. mutual fund investors have discovered emerging markets in a big way. Where does that leave you?**

We have had exposure in Europe and in Japan this year. We don't involve ourselves in emerging markets—not because there isn't an opportunity there. It's just that it is not what we do and where our expertise is. But we have 15-20% of the portfolio outside of the U.S. We have done well in both Europe and Japan year-to-date. Obviously, we are aware that flows from U.S. investors into non-U.S. equity mutual funds have been quite large. But it looks like they're peaking now and will moderate because dollar strength has taken away returns from U.S.-based individual investors. In any event, my sense is that the U.S. next year—holding aside questions about the currency for a moment—will do better than the European and the Japanese markets, just the reverse this year.

Lee: I just want to say, parenthetically, that Einhorn is the only guy I know over age 55 who's bullish.

**What about you?**

Well, I'm torn. Because I kind of feel that I understand all of the bullish arguments that I went through at the beginning of this conversation. Even more importantly, given what I do for a living, I could give you the names of 20 stocks that look to us to be extremely undervalued. Having said that, I just don't know if it is all being built on a very shaky foundation. A guy like Paul Volcker is no fool. He says there is a 75% probability of some kind of financial crisis in the next five years. Pete Peterson wrote *Running On Empty*, and he and a lot of other very smart people—including Bob Rubin—all seem to have a very pessimistic take on the drift of our fiscal policy, and of our international competitiveness and of our

reliance upon foreign capital. The thing is, you know, I'm a poor kid out of the South Bronx. I don't have a Ph.D. in economics. I actually do have a Ph.D., but not in economics. It's an honorary doctorate in finance from Roger Williams University. But what I was getting at is that—without taking anything away from any of those very smart people, when you step back and look at it, the people who are very pessimistic about the economy have been pessimistic, really, for 35 years. And, in this business, the difference between being early and being wrong, is almost imperceptible so—

**So you're a more skittish bull than Steve?**

**Steve:** I would say that the burden of proof about all these structural imbalances—the trade deficit posing a problem, the budget deficit posing a problem, housing posing a problem, the leveraged consumer posing a problem—the burden of proof is on the bears, not the bulls. Because so far none of those structural imbalances, as they are referred to, has had any negative impact that we can see on the economy or on inflation. So these structural imbalances are interesting to talk about at a cocktail party, to make one sound worldly. But the burden of proof is on the permabears to show that they are meaningful as something other than intellectual fodder.

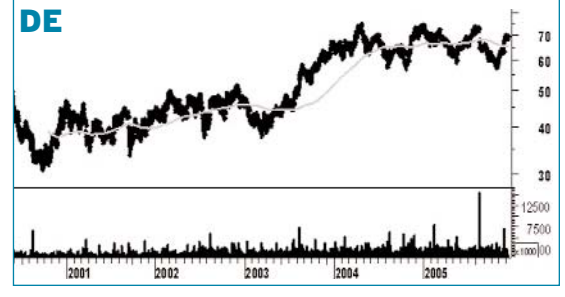
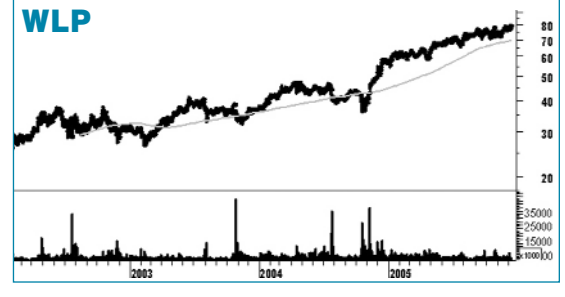
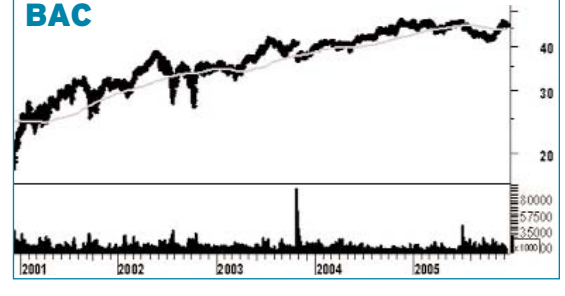
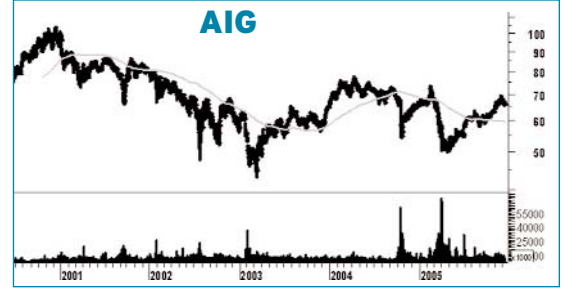
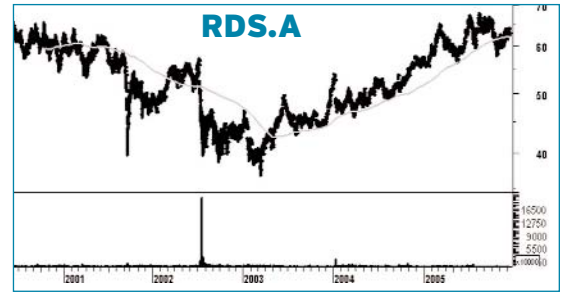
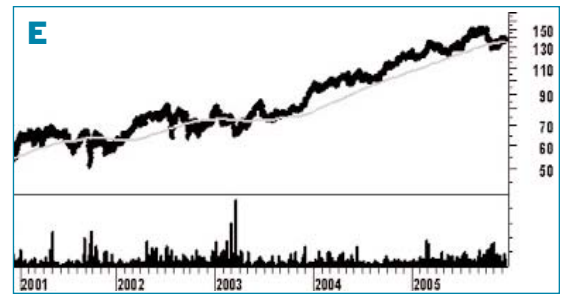
**Lee:** In all fairness, I understand what Steve is saying. But I'm one of these guys who, as a citizen, is concerned. Professionally, I'm going with our analytical work. I'm going with the values that we see within the market. But I have to admit, as a 62-year-old citizen, that I'm concerned with the drift of our fiscal policy. I'm concerned with the migration of our employment overseas and with our lack of competitiveness. I mentioned the old saw about "three steps and stumble." Well, here is another saw: "If the President is in trouble, the market is in trouble." This President is in trouble. But none of this stuff seems to be having much of an effect, so I guess you have to call us complacent.

**Steve:** You know on the risk side, and its important to always discuss the risk – the thing that worries me the most is, in fact, the disarray in the Republican Party because it has direct consequences in terms of fiscal policy. A Republican Senate was unable to extend the dividend and capital gains tax cut from 2008 to 2010 a few days ago.

**Lee:** The Republican Senate was also unable to pass the budget cuts proposed by Bush, and a Republican Senate was unable to keep drilling in Alaska in the latest budget proposal. That, to me, is problematic because it's a reversal of pro-growth incentive policies that were part and parcel of a Republican-controlled Senate and House and Administration that aided the market. All that looks vulnerable now. If there is a risk out there, other than the structural ones we have typically talked about, it is the disarray developing in the Republican Party and its inability to continue the agenda of pro-growth tax cuts that we've had in the last several years.

**In part, because the Republicans have been spending like Democrats.**

**Lee:** I agree, but what's really happening here is that we have evolved this mercantilist relationship with the Chinese. They have serious domestic economic issues, they need to employ all their people flooding into the cities from the countryside. And I guess that as long as they're willing to hold our monetary liabilities in exchange for exporting goods and services to us, this game could go on for much longer than you and I think. So what you have got to do is watch the dollar exchange rate. You have got to watch interest rates. You have got to watch currencies. You have got to watch employment trends and, obviously, be prepared to change your mind. But I'd say right now things seem to be reasonably stable. Maybe what's really happening here is that the world has figured out that we have less than fully prudent policies. Because if you look around the world, who would have thought—with corporate profits and dividends doing what they're doing, that the U.S. would have the *worst-performing* stock market in the world? But in local currency terms, as of the moment we're speaking, the Dow for the year is down 1%. The S&P is up 1%. The FTSE is up 13%, the CAC is up 18%, the DAX is up 19%, Spain is up 14%, the Swiss market is up 27%, and the Nikkei is up 23%.



So think about it: We are having wonderful economic growth, strong corporate profits, double-digit dividend growth, yet we have the worst-performing stock market in the world. So maybe people are figuring out that we don't have exactly the best structure. But we just don't know. So there are a lot of issues, and we're watching them all very carefully. But we are also finding *a lot* of cheap stocks.

**Tell me about those. I've heard a lot whining lately that small and mid-caps, especially, aren't bargains any more.**

**Lee:** Well, we don't look at those things, we're not small cap managers. But I just came back Saturday night [Nov. 12] from the Lyford Cay conference that Morgan Stanley sponsors, where I made five recommendations, and I'd recommend them all here, too. I recommend Tyco at about \$26.50, and that's up about 2 bucks already. But it's up this morning because the company had a conference call and said what I thought they would say: that their stock is significantly undervalued and that they are intent on pursuing activities that will create value for shareholders. I'm sure they've got plenty of pieces within Tyco that could be attractive to LBO guys. We continue to think **Tyco Industries** (TYC) is attractive here. It's a multi-industry company. We think management is intent on creating value. They won't be the first conglomerate to figure out that value might be created by dismembering and disaggregating. As I said to them on the conference call this morning when they alluded to that possibility, "Don't think you're blazing any new trails. ITT, Litton Industries, Walter Kidde & Co., Gulf & Western, City Investing, Teledyne and a number of others have preceded you in reaching that conclusion." Because what happens in a desultory market environment is that the whole sells for less than the sum of the parts and the management feels motivated to do something to surface value. In addition, in the case of Tyco, they have enormous free cash flow, plenty of unutilized debt capacity. This company generates \$4 billion-plus in free cash flow. Its debt is less than one times EBITDA, and they are in a position to create value through the use of the balance sheet. So we like Tyco.

**You've liked Tyco for a long time, Lee, if not always its management.**

We have a nice profit with Tyco.

**Do you?**

Yes. Well, we lost a lot of money in Tyco in 2002, but we averaged down quite dramatically when **Dennis Kozlowski** was under siege and now we have a very big profit. If you give me a second, I will tell you—We brought our cost up recently because we bought more stock. I am not bragging, not complaining, but our cost basis in Tyco is \$23.14. So it's trading at 28-29; it's okay.

**What else do you find cheap?**

We're long-term bulls on the energy group. So we like a lot of things associated with energy. Our favorite is **Transocean Inc.** (RIG), the offshore drilling company, which I recommended at Lyford Cay at about \$57.50, which is about where it is today [Nov. 15.] They own 25% of the world's supply of fifth-generation deep-water drilling rigs; day rates on those rigs have literally tripled over the last two years. There is no consequential supply of new rigs coming on until probably 2009-2010. We think they will ramp up earnings over the next three years to in excess of \$8 a share in 2007. So the stock, trading around 57, is only at about 7 times earnings. They just announced about a month or so ago a \$2 billion buyback, which will be paid for out of surplus cash flow—that represents about 12% of the company. So we like Transocean. We think the value

in Transocean approaches \$80. I think the value, in the case of Tyco, by the way, is somewhere between \$35 and \$40.

**What else do you like in the energy arena?**

Here is an idea that is off the beaten track. One of my partners just got back from China and spent a couple of days visiting with **Shenhua Energy** (1088 HK), which is the largest coal company in China. They are producing presently about 120 million tons of coal, which would make them, I think, the second-largest coal producer in the world. Their objective is to produce 200 million tons of coal within five years. So you're getting significant growth in production and in demand. In the last 20 years, China's real GDP has grown about 9% a year, and most people I talk to who are experts on China expect its GDP growth rate to be only modestly less than that over the next five years. So you've got very strong growth in demand. You've got strong growth in production.

**But is it profitable?**

Yes. This company earns almost \$2 billion a year, so it's a major-league company. It has got a market cap of \$20 billion. It owns its own railroad lines. It owns its port facilities and it has a 50-year-plus reserve life. Yet you can buy this thing for something between 7 and 8 times earnings. And we think they'll pay dividend in the first half of next year, equal to almost 4% of the price of the stock. So you've probably got a 4% dividend yield. You've got a less than an 8 multiple, and you've got a company that's probably going to grow 15% per annum over the next four or five years. It sells at less than half the multiple of U.S. coal companies—despite a better reserve base and a better production profile. So we like Shenhua Energy a lot.

**How much of Shenhua Energy does the government own?**

I would guess about 80% They sold off 20%. The IPO took place at \$7.50 and the stock is at about \$8, so it's not up very much. All these H-shares in Hong Kong have not traded well. That ultimately will take care of itself. I'm just looking at it as a business that is very undervalued. Either that, or the guy I sent over there to look at it doesn't know what he is talking about. Let me read you part of the write-up my guy sent me: "Net income margins 35%, more than twice the U.S. coal companies. Free cash flow in '05, \$2 billion. Projected dividend yield between 3.5% and 4%." As I mentioned, "their production, currently about 120 million tons, is budgeted to go to 200 million tons over the next 5 years. That's about a 15% growth rate in production. Imported coal is hardly competitive. The shipping cost to ship coal to China is about equal to what it costs Shenhua to produce coal on its own. So the likelihood of significant import competition doesn't really exist." And the outlook for growth in China, I think, is very obvious. I don't open up a box of anything I buy anymore that doesn't say "made in China." I don't know about you, but that's my anecdotal type experience.

**Mine too, but how about another idea closer to home?**

Here's another stock I recommend on totally the other end of the spectrum: **Freddie Mac** (FRE). It is right now laboring under an OFHEO [Office of Federal Housing Enterprise Oversight] capital surcharge equal to about \$10.8 billion. They have to keep 30% excess capital until they get their accounting current. They've told the world that their accounting will be current in the first quarter of '06. So that would theoretically release the \$10.8 billion of surplus capital that they now have to keep on their balance sheet. In addition, they have said publicly that they have another \$5 billion of excess capital on top of the OFHEO-mandated excess capital. So in Freddie Mac, you've got a company with \$15 billion of excess capital—and with a market cap of just \$43 billion. So almost 40% of the market cap is accounted for by excess capital. We would characterize 2006 as a year in which Freddie Mac will take signifi-

cant strides to return excess capital to shareholders. About a month and a half ago, they announced a \$2 billion buyback, which is 5% of the company, roughly. We expect a significant dividend increase possibly as early as the first week of December [FRE's board announced a 12-cent or 34% increase in the company's dividend, to 47 cents quarterly, on Dec. 1.] And then we expect to see other significant moves to create value for shareholders. They seem to have recurrent earnings of \$6-plus, and the capitalization shrink should be additive to earnings per share. So we like that Freddie Mac. At 63, which is where it was when I talked about it down in Lyford Cay, and about where it is today, it has a nice risk /reward ratio.

### What's your fifth idea?

A little specialty company—actually, it's not little. This company does \$6.5 billion of revenue. It was selling for around \$43 and change a share when I was down in the Bahamas. It's around \$44 and change now. We think it will earn over \$4 next year.

### How about a name?

This company is called **Autoliv**. ALV is the symbol. They're the world's largest manufacturer of safety restraint systems for automobiles. This really is a global company. They're incorporated in the United States. They're based in Sweden and they sell to all the major auto companies. Only 15% of their revenues are from U.S. manufacturers, close to 60% are from Europeans, and the balance of close to 30% are from Chinese and Japanese automobile manufacturers. So it's a world company. Worldwide auto production grows about 2.5% per annum. There is mandated safety legislation that will give Autoliv another 3-3.5% revenue growth from increasing its content in automobiles, and over time, it should get maybe a 1% increase in selling prices. So all together, it could generate 6-7% top-line growth. With some margin expansion, I expect they can grow their earnings 10% a year. But the interesting twist here is that if you go into their website, they post their buyback activity on a daily basis. They tell you every day how much stock they've bought back.

### That's full disclosure.

Yes. And they've been buying back close to 100,000 shares a day. There are about 3 million [now 2 million] shares left in the buyback authorization. So far, this year, the company has bought back 6.7 million now [8.2 million] shares. They've reduced their share count to about 85 million [now not quite 84 million]. And we're comfortable that they will reauthorize when they complete this buyback program. They just increased their credit lines. In 2004, the company bought back 3.4 million shares, and in 2003, they bought back 2 million shares. So they have been a persistent acquirer of their own shares.

### Knowing you, they must be doing that at prices favorable to the remaining shareholders—

Absolutely. We have put the company through an LBO model, and we think a private equity guy could afford to pay at least the mid-50s, if not more, to buy this company. It's a world-class company. It is selling for only around 10 times earnings, and—for whatever reason—TRW, which is a competitor of Autoliv, is selling almost at 14 times earnings. So we think Autoliv is attractive. We're very happy with its management. They are first-class in every respect. They have been trying to create wealth for shareholders. I wouldn't be shocked if somebody tried to buy them. But even if someone doesn't buy Autoliv, I'm getting it at 10 times earnings and it is shrinking its equity base. They say on their website that they have as much as \$900 million of additional borrowing capacity in the company, which could buyback 20 million shares, or 25% of the company. And that borrowing capacity grows

over time with their earnings.

### Those are the five stocks you talked up at Morgan's big bucks boondoggle—but you said you have a long list of cheap stocks—

We do—but I don't want to take your whole day. We own some of the large integrated oil companies. They may have a time out here for a while, but on a two-year basis, we like **Total SA ADS**, [TOT] in France [Total closed at \$123.94 on the day of the interview, Nov. 15]. We like **ENI Sp.A.** [E, ADRs on NYSE] in Italy, trading today at \$132-134. We like **Royal Dutch Shell** [RDS.A] [around \$60-61 at the interview] for catch-up opportunities in the energy area. We like—we bought it very well—but we continue to like **AIG**, (**American International Group**) [at 66-67 during the interview]. We look at it as a world-class business franchise; a 15% growth opportunity. We like **Bank of America** (BAC), selling at under 10 times earnings at 45 and change, yielding about 4.5%. We like **Wellpoint** (WLP), which we have more than a double in—it's a big position for us—even at 75, where it is today. We think it's a 15% grower, it's selling around 13 times next year's earnings. We like **Deere & Co.** (DE) [at 63] in the industrial equipment area, because of its 10% free cash flow yield, and its large buyback in place. In the media area, we have decent-size positions in **News Corp.** (NWS) and **Viacom** (VIA), which we think are undervalued [at, respectively, 15 and change and 32-33] and we own **Time Warner** (TWX) [around 17.50 during the interview]. We're prepared to let **Carl Icahn** do the heavy lifting, and we'll go along for the ride.

### What do you think Time Warner is worth?

Probably less than Icahn thinks, but we think it's worth over \$20 a share. We also have a decent-size position in **Altria Group** (MO) [around \$74.50 during interview], which we think is heading towards a break-up as its litigation gets cleaned up. The break-up value is somewhere in the area of 100 or so. And we like **SCI** [**Service Corp. International**], the funeral home operator, which sells at less than 10 times free cash flow, and is buying back a large amount of stock; it has a very strong balance sheet.

### You've also had a weakness for those funeral home operators for a long time, haven't you?

That's an old story. Now you're going to get into an ugly side of my life. You're going back to 1998, when I got involved in **Louwen Group**, which was a whole other, sad story. But SCI is different. We got into it around \$6.50, it's now around \$8.30, and the company has been a very significant buyer of their own stock, generating a lot of free cash flow. But we certainly don't have an affinity for funeral homes. We would like to avoid them—in the real world and in the investment world. But we think SCI is very cheap.

### You're probably right to expect the zillions being poured into private equity funds to find their way back into the market via buyouts of one sort or another. Any thoughts about what are the most likely candidates?

It's very hard to figure out. But like I said, Autoliv is a stock that—were a private equity guy to look at it—the conclusion would be that it is undervalued. We also think **Alliance Data Systems Corp.** (ADS) [trading between 35 and 36 during the interview] will be an interesting candidate. It is a big surplus cash flow generator.

**Steve:** If you do a screen looking for likely buyout candidates—and many have done just that—what you find is that

they are very broad-based. There is no one sector that tends to stand out. A very broad array of industries and sectors shows up when you screen for potential LBO candidates today, which I think is quite positive actually. It demonstrates on a bottoms-up basis, the under-valuation of the aggregate market relative to interest rates and the return on capital and the like.

**Lee:** There's one other stock I should mention, because I've been dead wrong about it. You know, at times when you are wrong, you turn around and sell out; admit your mistake. Other times, you average down. But I have just been holding onto this. I have a decent-size position in **EchoStar Communications** (DISH), the satellite operator. I've been dead wrong; the stock is down at \$25.25 or so. But this company is run by a very smart guy and it's a very valuable business. [EchoStar Chairman and CEO] **Charlie Ergen** is nobody's fool, and the company has been a reasonably persistent buyer of its own stock—which continues to go down. I don't think he's going to do this, but I've looked at models that suggest Ergen could take the company private at \$40 a share. In 2002, EchoStar bought back \$1 billion dollars worth of stock. In 2003, it bought back \$190 million, in 2004, it bought back \$800 million worth of stock. And so far this year, it has bought back about \$150 million of stock. Ergen himself owns \$5-plus billion of stock, or 52% of the company, and the company is a big free cash flow generator. But the market is very fearful that there is too much competition in this space. So far, the market has been right and I've been wrong. Satellite is competing with cable and cable is

competing with the telephone companies. But there are a lot of rural subscribers to EchoStar, for whom cable is not really an effective alternative. One day, these guys could be acquired by somebody. They have 12 million subscribers. It's a very valuable distribution platform. Whether its SBC or Verizon or Disney or Viacom, I don't know. They are all potential buyers of a company like this. In the meantime, EchoStar is doing the best job it can of running the company. The one thing we know is that financial companies are not going to go private through LBOs, but there are plenty of manufacturing companies that could.

#### You do have a long buy list.

**Lee:** There's one other company I should mention that we like in the energy group: **Lukoil Holdings ADS** (LUKOY) the Russian oil company. It's one of the few major oil companies in the world that will increase its production over the next decade—probably by 6-7% per annum. **Conoco-Phillips** (COP) owns 12-13% of the company, and they're committed to go to 20%. I found it very interesting that the oligarchs who control Lukoil would not sell their own shares to Conoco-Phillips. They said, "If you want to go to 20%, you go into the open market." They probably know more about what they've got than anybody. I look at that as very constructive to Lukoil. It's worth probably 40% more than it's trading for [\$46 on Nov. 15]. Of course, you've got issues in Russia with the rule of law, but hopefully, these guys will stay out of the political arena and stay free. **That's an appropriately seasonal note of peace on earth, goodwill to men. Thanks, gentlemen.**

#### Welling@Weeden Staff Conflicts Avoidance Policy Disclosures

In keeping with Weeden & Co. LP's reputation for absolute integrity in its dealings with its institutional clients, welling@weeden believes that its own reputation for independence and integrity are essential to its mission. Our readers must be able to assume that we have no hidden agendas; that our facts are thoroughly researched and fairly presented and that when published our analyses reflect our best judgments, not vested pocketbook interests of our sources, colleagues or ourselves. Neither Weeden & Co. LP nor w@w engage in investment banking; w@w's mission is strictly research.

All information gathered by welling@weeden editorial staff in connection with her/his job is strictly the property of welling@weeden. It is never to be disclosed prior to publication to anyone outside of welling@weeden. Editorial staff (a group broadly defined to include Kate Welling's immediate family) will not buy or sell any security mentioned in the journal for at least one week after publication. Staff will avoid not only speculation but the appearance of speculation and may not engage in short-term trading, the short selling of securities, or the purchase or sale of options or futures. Staff may not be otherwise compensated for securities recommendations in these pages. No w@w staff will serve as an officer or director of any publicly traded company. All securities positions entered into by w@w editorial staff will be held for at least six months unless dispensation is received, in extraordinary situations, from Weeden & Co. LP's compliance officer. Any securities position in any company, mutual fund or partnership portfolio featured in welling@weeden that was acquired by staff in advance of the publication decision will be specifically disclosed at first mention. [No such reportable positions exist.] And that position will be frozen for six months from date of publication, again, absent extraordinary dispensation from compliance.

#### Weeden & Co. LP's Research Disclosures

This material is based on data from sources we consider to be accurate and reliable, but it is not guaranteed as to accuracy and does not purport to be complete. Opinions and projections found in this report reflect either our opinion (or that of the named analyst interviewed) as of the report date and are subject to change without notice. When an unaffiliated interviewee's opinions and projections are reported, Weeden & Co. is relying on the accuracy and completeness of that individual/firm's own research disclosures and assumes no liability for same, beyond reprinting them in an adjacent box. This report is neither intended nor should it be construed as an offer to sell or solicitation or basis for any contract, for the purchase of any security or financial product. Nor has any determination been made that any particular security is suitable for any client. Nothing contained herein is intended to be, nor should it be considered, investment advice. This report does not provide sufficient information upon which to base an investment decision. You are advised to consult with your broker or other financial advisors or professionals as appropriate to verify pricing and other information. Weeden & Co. LP, its affiliates, directors, officers and associates do not assume any liability for losses that may result from the reliance by any person upon any such information or opinions. Past performance of securities or any financial instruments is not indicative of future performance. From time to time, this firm, its affiliates, and/or its individual officers and/or members of their families may have a position in the subject securities which may be consistent with or contrary to the recommendations contained herein; and may make purchases and/or sales of those securities in the open market or otherwise. Weeden & Co. LP makes a market in EchoStar Communications (DISH). Weeden & Co. LP is a member of NASD and SIPC.

#### talkback

### Photo Snafu

Lovely article... Thank you... Pen Hadow will be delighted. He's the guy in the picture... He's better looking than me so I am not phased!!!! Again many thanks for very supportive and very lively article.

**Simon Murray**

November 27, 2005

Simon@simonmurray.co.uk

**KMW replies:** If it's any consolation (for you, I'm inconsolable), you've had a unique experience. I've never made that particular utterly embarrassing journalistic mistake before.

In any event, the proper picture is now on the website and will appear in a correction in my next print issue.

Fact is, you are easier to look at. I mistakenly assumed the rigors of expedition you described had taken quite a toll.



Simon Murray



Pen Hadow

**W@W interviewee Research Disclosure:** Omega Advisors Inc.'s portfolio holdings and manager views are based on information from sources believed to be reliable but their accuracy and completeness—much less the market performance of their ideas—are not guaranteed. What's more, they are subject to change without notice, and discussions of portfolio holdings are intended only as illustrations of investment strategy, not as recommendations or as offers to sell or solicitations to buy securities mentioned. Not all portfolio holdings experienced similar results as those discussed. Holdings may gain or lose value. Employees of Omega Advisors may from time to time serve as directors of portfolio companies, where Omega believes this would benefit its funds. Investors should understand that in such a case, the funds' freedom to trade in the securities of the respective company may from time to time be restricted, which could adversely affect the funds. Additionally, employees of Omega may from time to time invest in the securities of portfolio companies. For complete information, contact Omega Advisors, Inc. Wall Street Plaza, 88 Pine Street, 31st Floor, NY, NY 10005. (212) 594-5210