93/01-Besting the Blundering Herd

By Peter Lynch

Nothing bedevils the average investor more than the false sense of inferiority that comes from playing against the institutions. After all, the institutions are so big, and get so much attention for dominating the markets, that the amateur stockpicker can't help but feel that he's trapped in a fantasy baseball camp, competing against the Atlanta Braves.

I've said this before, but having had nearly three years to reflect on life in the pro ranks on Wall Street, I'm still convinced that it's not the Atlanta Braves, or even the Toledo Mud Hens, that the average investor is competing against. It's more the Thundering Herd.

"Thundering Herd," as you may recall, is how the financial press once described the great mass of stockbrokers hired by Merrill Lynch to service the average investor, back in the days when average investors bought and sold most of the stocks. Today there's another kind of Thundering Herd on Wall Street: institutional investors, including the mutual fund managers, who now do most of the buying and selling.

A sizeable faction of this Thundering Herd could even be called the Blundering Herd. I can say that with confidence, having ridden with the Blundering Herd on more occasions than I care to admit.

The fact that the professionals now dominate the markets, which so often leads people to conclude that the amateur has no chance, has actually improved the amateur's chance. He or she can take an independent tack by zigging when the Herd zags and buying stocks that the Herd has overlooked, and especially the ones that the Herd has recently trampled. What holds them back is the inferiority complex they've gotten from mistaking a cattle drive for the Atlanta Braves.

The inferiority complex causes investors to do one of three self- destructive things: (1) imitate the pros by buying "hot" stocks or trying to "catch the turn" in, say, IBM; (2) become "sophisticated" by investing in futures, options, options on futures, etc.; (3) buy what they've heard a pro has recommended, either in a magazine or on one of the popular financial news programs. Information on what the pros think is so readily available that the celebrity tip has replaced the old- fashioned tip from Uncle Harry as the most compelling reason to invest in a company.

Let's say that in the spirit of doing it yourself, you take money out of your savings account at the local S&L;, America First and Foremost, and decide to buy stock with it. You're somewhat intrigued by the fact that the price of the common stock of America First and Foremost has fallen in half. You know this to be a solid institution with a strong balance sheet and no commercial lending because you checked into these things before you put your money there. (Forgive me for using an S&L; example twice in the three columns I've written for this magazine, but lately I've been very taken with this sector.)

Just as you are about to pick up the phone and order the latest annual report from America F&F; to see if the story is as good on paper as it seems to be in real life, a little voice from the inferiority lobe whispers, "Who do you think you are, buying a stock in a company that has never been touted in Barron's, Forbes, or Business Week?"

So instead of ordering the annual report, you go to the newsstand to pick up their latest copies to see what the experts are saying, and in one of them you discover that Mario Gabelli owns shares in Coca-

Cola Enterprises, a bottling company for the world's favorite soft drink. You buy the stock, on the theory that a famous fund manager like Gabelli knows a lot more than you and your Uncle Harry put together. In fact, Gabelli does know a lot more than you and everybody's Uncle Harry put together, but that doesn't mean you're going to profit by betting on his tip regarding Coca-Cola Enterprises. (I mention this company because three years ago I, too, recommended it in Barron's at a price $3 higher than its current price of $11 a share.)

Since Gabelli doesn't give out his home phone number, you can't call him up to ask if he still likes Coca-Cola Enterprises and whether he views the price drop as an opportunity to buy more, or whether he has soured on the company and gotten out of the stock to cut his losses.

Most likely, the drop in the price will cause you to lose faith in the stock, and without Gabelli to reassure you, you sell your shares to cut your own losses - maybe you've even sold them to Gabelli! Then you take your diminished capital and repeat the process with another celebrity tip, perhaps from an analyst at your brokerage firm. If you cut enough losses, sooner or later there's nothing left to cut.

Picking your own stocks in this popular fashion only confirms what you have always suspected: There is no way an amateur investor can compete with the Atlanta Braves. If you're lucky enough to become totally demoralized before the money runs out, you'll send the remains to a mutual fund. My advice here is that if you want to bet on the pros, the way to do it is to invest in their funds to get the full benefit from their expertise coming and going.

I suspect that amateur stockpickers would have a much higher opinion of their abilities, as well as a greater net worth, if they avoided all expert buy recommendations in favor of their own research. This is the only kind of "independent investing" that makes sense.It's taken me three columns to get around to saying this, but the investor's edge is something you already have, not something you acquire by listening to the latest tips from notable sources. As a depositor at America First and Foremost, you are close enough to the situation to at least have a chance of keeping track of it, and also a chance of buying the stock at a bargain price before the Herd comes back.

Actually, there are two kinds of investor's edges: the on-the-job edge, in which you have a working relationship with an industry and the related companies with whom you do business; and the consumer's edge, with which you can capitalize on your experiences in restaurants, airports, and shopping malls.

In fact, of the 20 top-performing stocks on the New York Stock Exchange in the last decade, no fewer than six (Home Depot, Circuit City, the Gap, Wal-Mart Stores, Liz Claiborne, and Dillard Department Stores) have been stuck under the noses of millions of shoppers who, if they'd paid attention to the popularity of these enterprises, could have profited from their edge. And they had time to do so: It often takes 15 years for a retailer or a restaurant chain to expand across the country, as more and more investors become aware of it, before the Wall Street professionals catch on.

The line about New York, "If I can make it there, I'll make it anywhere," may be true for singers, comedians, and cab drivers, but public companies routinely make it in dozens of places before the news of their success reaches the institutional trading desks in New York or Boston, the two places where most of the Thundering Herd is corralled.

A colleague of mine on the board of Morrison Knudsen, Irene Peden, recently used her coffee lover's edge and bought shares in Starbucks, the popular Seattle coffee company. Peden is a professor of electrical engineering and an expert in subsurface remote sensing, whatever that is, and she always starts her day with a cup of Starbucks coffee. She became a fan of Starbucks back in Seattle, where she normally resides, but now that she's on temporary assignment in Washington, D.C., she gets the Starbucks beans sent to her.

Except for the shares she owns in companies on whose boards she serves, Peden had never bought a single stock until last year, when Starbucks came public. Her own experience with Starbucks convinced her the company had two great advantages: It made a product that people wanted, and it sold it at a profit.

Peden did not have to look far under the subsurface to find out that Starbucks was well-capitalized, with earnings growing at a steady pace, and that it had begun to expand east and south out of the Seattle area. The story is still a good one, and so far the stock has done well.

Cheryl Peterson, who recently retired from a local charity in which I'm involved, used her letter writer's edge and bought shares in Mail Boxes Etc., which sells stamps, mails packages, and rents boxes to people who are tired of waiting in line at the post office. This is basically the same story as Starbucks's: good company, strong balance sheet, and a huge potential market - millions of Americans who are fed up with the post office. The stock was first offered at just under $2 a share (adjusted for splits) and is worth $15 today.

Here's another one: Any subscriber to a computer magazine or owner of an IBM personal computer or IBM clone could have used the consumer's edge and discovered Microsoft. Practically every IBM-based PC you buy comes with the Microsoft disk operating system (MS/DOS), for which Microsoft has the exclusive rights. You can't run the machine without DOS. Microsoft's virtual monopoly on this product puts it in the same enviable position as a < wam-co NYSE:GT>Goodyear with the exclusive right to make all the tires for all the cars on the road. But even if you failed to recognize DOS as a potential profitmaker at the onset, once the company went public in 1986, you had other chances to follow its progress each time the company innovated. Microsoft continued to boast steady earnings growth as it introduced "Word," "Windows," various products for the Macintosh line, and "Excel," its spreadsheet that challenged the popular Lotus version.

Making computers has been a treacherous business, with too many competitors killing each other off, but what was bad for them was good for Microsoft because every time IBM sold a computer with DOS, Microsoft made a profit. While many individual investors were busy trying to think like the pros and figure out how to catch the turn in IBM, they should have been thinking like amateurs, looking for clues in their PCWeek or in their computer boxes (they'd have noticed Microsoft software in every one of them). I wish I'd noticed myself. The stock has been a 35-bagger.

In my recent travels, I have noticed Au Bon Pain, a name I continue to mispronounce, beginning with the "O," which I call "Ow," and ending with the "Pan," which I call "Paw." This croissant-and-coffee franchise has appeared in airports and food courts in malls, where people like me have a chance to use their croissant- lover's edge. The company went public only recently, but it's been in business for more than a decade. It has a good balance sheet, well- conceived plans for expansion, and so far it's only in a few major markets - but don't take my word for it. Do your homework.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best-performing of all mutual funds over a 15-year period. He is currently a trustee of the Fidelity Group of funds, and is working on a book to be published next spring by Simon & Schuster.

93/02-Buy American

By Peter Lynch

The romance with foreign stocks continues. What started in the mutual funds has spread to the pension funds. The California Public Employee Retirement System poured $7.3 billion into foreign stocks in 1991, and, not to be left out, the New York State Teachers' Retirement System invested $750 million in 1992. Our largest 200 pension funds now have $75.6 billion invested abroad--more than seven times as much as they did in 1985.

In effect, U.S. pension managers are betting increasing amounts on the notion that foreign companies will outperform the home-grown variety that got us this far. The subtext is that Wall Street can no longer compete with the Paris Bourse or the Hong Kong Ordinaries. If what's made in America is second-rate, the story goes, then so are the companies that do the making.

Let me be the first to throw myself in front of this bandwagon. It is remarkably short-sighted to invest willy-nilly in foreign stocks when you could be investing in America. In the ten years since foreign stocks have become fashionable, U.S. companies have become more competitive. Even our railroads are beginning to look good.

U.S. railroads are a cherished symbol of great American ineptitude. My generation was raised on the idea that Americans couldn't run one, and that the purpose of the industry was to support large numbers of aimless individuals, a sort of welfare state on wheels. Behind each train was the red caboose, a vestigial organ tacked on by the unions in order to house the pinochle players sitting on the featherbeds.

Slowly but surely, the railroad companies have tossed out the featherbeds and eliminated the cabooses, and last year the industry's return on investment was the best in about 50 years. The average crew size is declining and the volume of traffic is increasing, as railroads are hauling more coal and grain. They are even taking some container business away from the truckers.

The railroad shares still sell at a large discount to the market, so Wall Street does not yet fully believe in this transformation. Nevertheless, companies such as Norfolk Southern, Burlington Northern, Union Pacific, and Conrail prove that America can make the trains run at a profit, and perhaps even on time.

The United States still leads the world in airplanes (Boeing) and in tractors (Caterpillar). Caterpillar is recognized worldwide as producing what once would have been called the Cadillacs of farm equipment--before Cadillac lost its place at the pinnacle of automotive craftsmanship. Detroit, says the tune from the bandwagon, has forgotten how to make cars.

Really? I'll grant you that it's difficult, if not impossible, to determine the nationality of a car, which has begun to resemble the military brat, raised a little here and a little there. That said, the most successful car product of the last decade did not come from the drawing boards in Japan or Germany; it came from Detroit. I'm referring to the Chrysler minivan, which sells twice as many units in the United States per

year as all the Volvos, Lexuses, and Infinitis combined. So if foreign car companies make such an obviously superior product, why did some 450,000 Americans buy Chrysler minivans last year, while only 70,000 bought Volvos?

Perhaps we should say that Caterpillar is the Chrysler minivan of farm equipment. And when it comes to the farm itself, U.S. agriculture has hardly been resting on its cornucopia. U.S. companies are leading the world not only in tractors, in fertilizers, and in food processing (< wam-co NYSE:CAG>ConAgra's stock is up almost fifteen-fold in ten years), but also in genetic hybrids.

You wouldn't think it takes much intelligence to come up with a seed, but the seed-making business now resembles the pharmaceutical business in its astounding complexity. New seeds must face years of clinical trials and run a gauntlet of government approvals before they can be sown.

We've already proven our ability to be among the best in the world of pharmaceuticals (Merck, Upjohn Co., and Bristol-Myers Squibb), and we're repeating the performance in agriculture with DEKALB Genetics and Pioneer Hi-Bred International. DEKALB has been producing hybrid hens since the mid '40s and hybrid swine (bigger litters, fatter porkers) for 20 years, and has recently made progress with its hybrid seed corn. The leading brand of hybrid seed corn in France is marketed by Pioneer Hi-Bred, a triumph in a country that treats home-grown food with the respect that we give our nation's flag. Calgene, Inc., is working on a genetically engineered tomato, Monsanto on a superior, pest-resistant potato that may inspire a rewrite of the famous ditty: You say potato, I say Monsanto.

Likewise, the U.S. steel industry, once left for dead in the Rust Belt, is showing signs of life, especially in companies such as Nucor, a spectacular enterprise that has introduced efficient mini-mills. Even the fallen mastodons, such as Bethlehem Steel, Inland Steel , and USX (the former U.S. Steel), are beginning to stir.

America's loss of the TV market to the Japanese has created the impression that America is unable to compete with the Japanese in electronics. In fact, our position in this industry is still strong at home and overseas. While it's true that the TV-manufacturing business has been captured by the Japanese, they aren't making money in it like they used to, so to this market we can say good riddance. Moreover, this popular theory that the United States can't compete in electronics is disproven by Motorola, a world-class supplier of semiconductors and the world's leading supplier of cellular phones and mobile radios. Their foreign operations account for 42% of sales, and they are the only non-Japanese supplier of car phones and pagers to Nippon Telegraph & Telephone.

As for who will control the computer business, I heartily endorse the opinion expressed by Alan Ryan in a recent issue of The New York Review of Books: "The mass production of computer chips now lies largely in the hands of NEC, Toshiba, and Hitachi, but it is widely believed that the American firm Intel will wipe the floor with them during the next decade."

We can't deny that the Japanese took over the camera business and became their own best customers, but, like TVs, cameras are not profitable per se. Film is where the money is, and although Fuji has made inroads with U.S. customers, its major U.S. competitor, Kodak, still has a higher market share for film in Japan than Fuji and all other Japanese producers have here. Cambridge, Massachusetts-based Polaroid, of course, continues to have a lock on the instant-gratification market worldwide.

Speaking of locks, Gillette maintains its global domination of the razor trade, and political and corporate leaders across every continent (if they happen to be male) begin their day by pulling Gillettes across their cheeks--prima facie evidence that the United States is doing something right.

Meanwhile, we continue to export our fantasies, from Mickey Mouse to Madonna, along with our soft drinks, our fast-food chains, and our retail outlets. It's culturally correct for all U.S. travelers abroad to groan in dismay as we pass a McDonald's in Paris or a Toys "R" Us in Heidelberg, but these are sights we ought to celebrate. The more of this sort of culture we can export, the stronger our economy, and the more likely we'll all be able to afford to travel to Paris to admire the Mona Lisa and wince at McDonald's.

Back at home, we're creating more promising small growth companies of the kind that are listed on NASDAQ. Europe is particularly short on these emerging-growth opportunities, as the European economies are dominated by oversized conglomerates of which only some are making a decent level of earnings. While it's true that Japan has become a haven for small-company growth stocks, these are often so overpriced that the investor has little chance to gain on the upside, and Japan in general is having its troubles these days.

This brings me to the ultimate reason to prefer U.S. stocks: Wall Street provides a level playing field that exists almost nowhere else. Things we take for granted here--the timely settlement of stock trades, the timely receipt of dividends, the accurate reporting of earnings--cannot be taken for granted by shareholders in Latin America, Europe, and the Pacific Rim. Regulatory authorities elsewhere, whether in Malaysia or Mexico City, don't protect investors the same way the SEC does.

Throughout the 1980s, I made a lot of money in foreign stocks for the < wam-co FUND:FMAGX>Magellan Fund. This successful foray had nothing to do with foreign companies being superior to U.S. companies. Foreign stocks were so poorly covered and the reports so sketchy that many of the best companies were selling for a fraction of their actual worth. I found bargains galore, even among the most famous conglomerates (Nestle, Volvo, Unilever, Montedison), with nary an analyst to trumpet their virtue.

The popularity of global investing has caused prices to rise and bargains to disappear, but the primitive reporting system still exists. When you buy foreign stocks, you almost have to do your own research, or else rely on a fund manager's doing his or hers. Managing a portfolio of foreign stocks is a much harder job than managing a domestic portfolio.

There's a patriotic argument I haven't mentioned. Every dollar sent abroad robs an American company of capital it could use to grow. Someday there may be a backlash against owning foreign stocks, just as we've seen against owning foreign cars. Protesters may burn shares of foreign companies on the steps of the New York Stock Exchange, the way they bashed Japanese cars in American parking lots.

You don't have to be a patriot to invest in America--merely self- interested. We have a great system of reporting to protect shareholders. We have great industry leaders (Nike, Walt Disney, Ingersoll-Rand, Sallie Mae, and Federal Express, to add a few more names). When General Motors falters, we have at least three other five-star generals, General Re, General Mills, and General Electric, to pick up the slack with their great records.

There's nothing wrong with investing abroad if you're familiar with the territory. Given a choice between investing blindly in the future of Germany or the Pacific Rim or taking a more educated risk on Supercuts

or Au Bon Pain (two of my recent favorites), I'll choose the latter every time. It's in the backyard that investors find their edge.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best- performing of all mutual funds over a fifteen-year period. He is currently a trustee of the Fidelity Group of funds and has written a new book, Beating the Street, to be published this month by Simon & Schuster.

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93/03-IPOs Explained

By Peter Lynch

Every year, hundreds of new issues take their place on the ticker tapes. These financial newborns are called initial public offerings (IPOs), and how they are handled is one of the most fascinating stories on the Street.

Whereas for humans, life ends at the undertaker's, for common stocks, it begins at the underwriter's. Company X engages one of these Wall Street investment houses to peddle its first publicly traded shares, at a fixed price, to a group of initial buyers. Where to fix the price is a guessing game that puts the underwriter in a ticklish situation.

If the price is set too high, it will surely fall after the stock begins to trade freely, causing the initial buyers to lose money as well as any faith they may have had in the work of the underwriter. Since most of these buyers are big Wall Street institutions who do not take kindly to losing money, this result will not enhance the underwriter's popularity.

On the other hand, if the price is set too low, then the stock will soar in the market, making the initial buyers very happy-- but not so the company. Company X will realize it could have gotten much more for its shares had the underwriter set a higher price at the start. The next time it wants to do a deal, Company X will likely take its business elsewhere.

To satisfy both sides, the underwriter tries to price the new issue high enough so the company won't feel bamboozled, and low enough so the initial subscribers can make a bit of profit. In IPO circles this process is known as "leaving something on the table."

The underwriter, however, reserves the right to sell an additional amount of shares, usually about 10% of the offering shares, at the time of the offering. This is the "green shoe" allotment, named for the now- defunct Green Shoe Corp., for which the strategy of selling additional shares was invented. If all goes well, the stock price of the new issue will "lift" (another bit of IPO jargon) after it begins to trade freely on the open market. The green shoe shares can then be sold to add to the proceeds from the offering.

The deliberate pricing of deals slightly under the presumed market value is one reason IPOs do so well in the first three months of existence. In fact, if you'd bought shares in every IPO that appeared in the last ten years (I'm not counting penny stock IPOs here), held those shares for three months, then sold them and invested in the next batch of IPOs, you would have outperformed the S&P; 500 by a large margin.

Getting your hands on the shares of an attractive IPO is not easy. They are doled out by the underwriter to a who's who of pensions, mutual funds, and the like. Usually the best deals are oversubscribed. At Magellan , a constant frustration was getting excited about a new company and then discovering that I was allowed to buy only a piddling amount of stock.

If Magellan had this problem, you can imagine what chance the average investor has of participating in an attractive IPO. Brokerage houses get an allotment of shares, which they offer to their biggest and best clients. If you're not one of those and your broker offers to let you in on a "hot IPO," you ought to look this gift horse in the mouth. Why are the big investors avoiding this deal?

When Apple Computer went public in 1980, the state of Massachusetts, using the arcane Blue Sky laws, prohibited small investors from buying any shares. The idea was that Apple was such a risky venture that only professionals should participate. This ranks just behind the Boston Red Sox's decision to sell Babe Ruth as the worst ever made in my state. It was fortunate for me because it meant I got a big allotment in the Apple deal.

IPOs seem to come in waves, followed by calmer periods when there's relatively little action. There were waves in mid '81, between mid '83 and early '84, in 1987, and we're in the midst of one that began in late 1991. These waves correspond to peaks in the stock market when investors are euphoric and willing to pay top dollar for stocks. Companies wait for a giddy atmosphere in which to go public, which is why so many of them do it at the same time.

Some people argue that it's a mistake to buy IPOs in a giddy atmosphere, which may be true in general, but this is often when the best of the new issues make their debut. It was in July 1987 that a company called MBIA, Inc., was launched. This profitable insurer of municipal bonds came public at $23.50 and promptly dropped half its value on Black Monday in October. It's a $63 stock today.

Lessons From A Prospectus

If you miss out on an IPO, you can acquire as many shares as you want when the stock starts trading in the "aftermarket." I always search for bargains during the rare periods when the deals aren't lifting, as occurred in the summer of 1992, when 70% of the most recent 100 IPOs were selling at or below their original prices.

In looking through the list of new issues, I came across Taco Cabana, a chain of Tex-Mex restaurants. I got copies of all the relevant reports, one of which included a map of Texas covered with bright red chili peppers that represented each Taco Cabana outlet in the state, accompanied by the company billboard slogan toot if you like our borracho beans.

It's always a good idea to review the prospectuses. There are two of these. The first is called the red herring, named for the numerous warnings sprinkled throughout the text and printed in red. This is the provisional explanation of the deal, showing the range of prices at which the underwriter thinks the shares might be sold after the "road show," where investors are solicited. The final prospectus, with all the details worked out, is printed in black.

By comparing one prospectus with the other, you can see whether the road show was a success and the underwriters got their expected price, or whether a lack of enthusiasm caused them to have to reduce it.

In the Taco Cabana red herring, the underwriter said the deal would be priced somewhere in a range of $11 to $13, but in October 1992 it came public at $13.50. Obviously, investors were moderately excited about borracho beans.

A prospectus also tells you what happens to the money that was raised in the stock sale. The proceeds can go one of two places: into the corporate till (the best result) or into the pockets of the founders and directors who are selling their shares in the offering. Whenever I see insiders using the IPO as an excuse to cash out, I ask myself: If they have no faith in the future of their company, why should I?

In this instance, $20 million was going into the corporate till and $13 million to insiders. I also noted that 94 cents a share was going to the underwriters-- no wonder Wall Street firms love to handle IPOs. In the regular market, institutions make only three to five cents a share in commissions for doing stock trades.

Among the insiders, the chairman, who owned 2.046 million shares, was selling 754,500 of them to pocket a quick $10 million or so. I would have preferred that he keep all his shares, but among the many gossipy details in the red herring, I found his age: 65. A 65-year-old, I figure, has a right to enjoy some of his money, and he'd retained more than half his holdings. Meanwhile, the Prudential Venture Partners II, one of the original bankrollers of Taco Cabana when it was private, owned 2.9 million shares and were not parting with any of them. This was a positive sign.

The next point to consider was how the company will use its share of the proceeds. The red herring informed me that Taco Cabana was planning to reduce its overall debt from $10.4 million to $2.5 million. In fledgling public companies, it's always reassuring to see a strong balance sheet. A company with no debt will have a hard time going bankrupt.

Did management know what it was doing? On page 20 of the report, I learned that Taco Cabana had opened its first "Mexican patio cafe" in 1978, and since then had added 40 more company-owned patio cafes, mostly in Central and South Texas. The chairman had 36 years' experience in the restaurant business in San Antonio. The president had been a vice president at Fuddruckers, the vice president of operations was a vice president at Burger King, and a director was president and COO at Church's Fried Chicken. They knew their beef, their chicken, their beans.

Sales were on the increase and so were the earnings-- another good sign- - and the company was determined to put new chili peppers on the map, with 12 new company-owned patio cafes planned for 1993 and another 18 for 1994.

You discover a lot of interesting trivia in a prospectus, such as the fact that a Taco Cabana restaurant is painted vivid pink and open 24 hours a day, that the average check is $4.63 per person, and that 40% of the business is drive-through. You imagine yourself going to a pink building at 4 am to eat borracho beans, and you marvel at the hearts, minds, and stomachs of Texans.

It says here that it cost $900,000 to build a Taco Cabana and that each one is expected to bring in $1.8 million in average annual sales. A general rule for investing in restaurants is that annual sales should exceed the cost of construction. A two-to-one margin is quite favorable.

Alcohol (beer, I guess) accounted for only 6% of sales. I'm skittish about owning stock in restaurants that make most of their money on liquor. Liquor tastes the same everywhere, and a restaurant that becomes a bar is likely to lose its customers to a trendier bar.

With the stock at $13.50, Taco Cabana was selling for 18 times its estimated 1993 earnings of 75 cents. This was not an extravagant price tag for a fast-growing company in a stock market selling for 23 times earnings overall.

I'm not recommending that either of us buy shares in Taco Cabana. I'm using it to illustrate how much you can learn from reading prospectuses, and how it makes sense to investigate companies that have recently gone public.

New companies are routinely misunderstood and/or ignored by Wall Street, which makes these the perfect targets for individual investors who do independent research. There are several newsletters and advisory services that keep tabs on the latest IPOs. These include "Going Public/ The IPO Reporter," published by Investment Dealers' Digest in New York ($990.00 per year; 212-227-1200); "New Issues Digest," published by National Corporate Sciences, White Plains, NY ($425 per year; 914-421- 1500); and Standard & Poor's "Emerging & Special Situations," in New York ($223.50 per year; 800-221-5277).

In the chart on page 38, you can see the results from a few of the most profitable IPOs of the past 12 years. Most are household names already.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best- performing of all mutual funds over a 15-year period. He is a trustee of the Fidelity Group of funds and his new book, Beating the Street, will be published this month by Simon & Schuster.

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93/04

A Fad With Staying Power

By Peter Lynch

You've got your eye on a fine company. All the signs are favorable, but there's this nagging doubt that keeps you away from the stock. So you stand by with cash in you pocket as the company continues to thrive, and you watch the stock price rise accordingly. This leads to Unbuyer's Remorse, which I can't help feeling every time somebody mentions the CML Group. CML sells NordicTrack, and my nagging doubt about the future of living room skiing caused me to ignore the good news that has led to a tenfold gain in the stock price form late 1990 to 1992. I missed the entire move. But, in fact, there were many points along the way that an investor could have bought the stock and made money.

My relationship with CML (the monogram of the founder, Charles M. Leighton) goes back to the early 1980s, before CML had anything to do with menswear, Caroll Reed women's wear, and Boston Whaler. The corporate strategy was to reach the 30 t0 50 age group at work and at play. CML had figured out that this group was growing four times faster than any other age group in the population, and that it had a lot of money to spend.

I didn't own a Boston Whaler at the time (my family has since corrected this error by giving me one), but this was the most frequently sighted boat along the coastline, and I'd ridden in enough Whalers to be fully convinced of the superiority of the product. Meanwhile, on a trip to Baltimore, I was in need of a suit and I bought one at Britches of Georgetowne and wore it on "Wall Street Week" with Louis Rukeyser.

Still, wearing a CML suit and having ridden in CML boats did not cause me to recommend CML stock on Rukeyser's program, although CML was among the hundreds of holdings I'd acquired for the Magellan Fund, so I liked it well enough to have bought a sizeable chunk.

CML was one of those scattershot enterprises in which success in one division was counteracted by failure in another, so on the whole it didn't get very far. There was a stretch when Britches and Boston Whaler both did well, and CML made a big profit from Sybervision, which produced videotapes of athletes so that weekend hackers like me could improve our games by osmosis. Meanwhile, Caroll Reed was a drag on earnings, and Britches was expanding in too many directions at once. CML also had a lot of debt.

My favorite CML subsidiary was The Nature Company--where else can you buy your children a tyrannosaurus tooth? These award-winning stores reported a remarkable $600 per square foot in annual sales, a record that no other retail operation bigger than a hot dog stand could hope to match. Alas, there weren't enough Nature Company outlets to bail out the other CML businesses, especially during 1988-'89, when boat sales began to slump and Britches began to slip and Sybervision was no longer the rage. By the end of the decade, CML's financial condition had not improved. For several years, the stock had sold in a narrow range: $3 to $8. (I say narrow only because of the spurt that was about to occur, which carried the stock price to $33.50 as of this writing.)

This is where it pays to keep in touch. CML sold Boston Whaler and unloaded Sybervision and Caroll Reed in order to reduce debt and devote itself more fully to NordicTrack. The NordicTrack division had been rapidly gathering momentum since CML acquired it in 1986. In the first year, NordicTrack sold 30,000 exercise machines; in the third, 30,000; and, 140,000 by their fifth year. People who never skied cross country or even across the street were skiing in their living rooms.

We had a NordicTrack at home, an my wife, Carolyn, continued to use it regularly. I admired it from a distance, as a piece of sculpture, but I could see that it was well-built, and much less bulky than a rowing machine.

In late 1990 I was in a perfect position to take advantage of the positive developments. I knew that the company had restructured and that NordicTrack now accounted for over 90% of the earnings. I knew that NordicTrack sales were increasing at a phenomenal clip. I knew that NordicTrack was opening numerous retail outlets and kiosks where people could try out the equipment.

Prior to this, the only way you could buy a NordicTrack was by mail order or by calling an 800 number shown on the TV ads. Hundreds of thousands of customers had bought the $600 product sight unseen. There had to be millions more who would never purchase an expensive item from a TV offer but who would respond to a personal demonstration.

I was also getting positive recommendations from two professionals who had given me good advice in the past: Dick Goldstein, a successful private money manager based in Denver, Colorado; and Harry "Skip" Wells III, an analyst at Adams, Harkness & Hill, a regional brokerage firm in Boston. Goldstein told me CML had become his largest position. Wells had been following CML for almost a decade, even though he was getting little attention from Wall Street. In his CML reports, Wells gets so excited about fitness that he makes you want to stop reading and start doing sit-ups. He also gets very excited about the prospects for CML, since in his view we are at the beginning of a "fitness-wellness megatrend" and the potential market for NordicTrack equipment is huge.

So here I had two experts egging me on, NordicTrack sales increasing at 15% to 100% a year, the company reducing its debt, plus the dramatic new developments of the kiosks and the retail stores. Yet I avoided even thinking about buying CML stock, or about recommending it to any of the charities on whose investment committees I serve.

My Nagging Doubt Lobe was telling me that NordicTrack was a fad and not a megatrend, that most people attracted to exercise machines already owned one, and that they weren't likely to purchase a spare. Moreover, I imagined that thousands of former floor skiers had gotten tired of sliding their legs back and forth and had returned to the Jane Fonda workout tapes.

Many companies give investors a lot to worry about, but there are genuine worries and then there's the "bogeyman in the closet" variety. The bogeyman hasn't come out yet, and you're not sure he's in there, but you aren't about to poke around in the dark to prove that he isn't.

I've often alluded to the fact that the collapse of the housing market was the bogeyman in the closet that scared investors away from Fannie Mae, a solid company that on close inspection was a great investment and less risky than most. I'm constantly reminding people that for 15 years, the bogeyman of

too many McDonald's restaurants has been scaring investors away from that wonderful enterprise, even though the stock has gone up tenfold since people began to worry about a fatal glut. Yet here I was, worrying about the glut of NordicTracks and not doing the homework that might have put this fear to rest.

In hindsight, I wish I had dragged myself out to the Chestnut HIll Mall to visit the new NordicTrack retail store. I would have seen firsthand the array of new products--the NordicFitness chair, the NordicFlexGold body building machine, NordicRow TBX, the recumbent bike exerciser, and the various advancements in stationary skiing.

If I had watched the customers try out this equipment, perhaps i would have understood the importance of these retail outlets, which by 1992 accounted for about 25% of NordicTrack sales. Perhaps I would have taken Skip Wells's megatrend projections more seriously. Of the 10 million "fitness enthusiast households" in the United States, fewer than 4% currently own a NordicTrack, and on top of that, there are 45 million "fitness aware households" and 31 million "couch potato households" that might finally decide to start exercising.

One of the benefits of visiting a retail outlet is that it brings the numbers alive. You can study a company's earnings potential all day long, but bullish forecasts always seem more believable after you've seen the evidence in person at the mall. But I never gave myself a chance to view the evidence. I stayed at home and ignored all the positive signs, as CML's stock price rose from a low of $3.50 in late 1990 to $33 by the end of 1992.

Whenever you have a nagging doubt about a company that's doing well, it's human nature to think you're the only person who feels that way, but the truth is that every other would-be investor is as worried as you are. The bogeyman that causes you to ignore the good news is having the same effect on everybody else. The very existence of doubt creates the conditions for a big gain in the stock once the fears are put to rest. The trick is to put your fears to rest by doing the research and checking the facts--before the competition does.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best- performing of all mutual funds over a fifteen-year period. He is currently a trustee of the Fidelity Group of funds and has written a new book, Beating the Street, published by Simon & Schuster.

93/05

Bestowing Gifts

By Peter Lynch

Most of us spend more time building up our net worth than we do in figuring out how to give it away for maximum benefit. Nobody argues with the fact that you can't take it with you, but a lot of people try to delay letting go of it right up to their date of departure. Consequently, charity begins not at home, but at the reading of the will.

The retentive impulse can be very unfortunate for the people and organizations we'd most like to support. When charity begins at the reading of the will, the bulk of the money falls into the hands of the nation's biggest profligate: the federal government.

Uncle Sam's is the unkindest cut of all, the 55% federal tax on inheritance for the deceased in the top bracket. Many states also take their cut, which has caused a great migration of the elderly to places like Florida, which in addition to sunshine offers the warmth and comfort of no estate taxes. But moving to Florida for the postmortem tax break is hardly worth the effort. Most of what the state doesn't get, the feds will.

A 55% tax on inheritance makes death the equivalent of a 2,000-point drop in the current Dow Jones average, and this after all the years the deceased has paid taxes on capital gains and "unearned income." (While the government encourages us to save and invest, it persists in using this insulting term, which makes it sound as if we don't deserve the proceeds from the saving and investing we've managed to do. Here's a suggestion for President Clinton: Order the IRS to drop the phrase "unearned income" from all tax forms immediately.)

I'm straying away from my main point, which is that there are ways to insure that a greater percentage of any good fortune can be handed down to our children or to the worthy causes that we'd most like to support. A giveaway plan ought to be part of any investment strategy, for what's the use of struggling to accumulate net worth, and then allowing it to be carted off to Washington by strangers?

The government offers us various ways to avoid the ultimate tax, beginning with the onetime contribution of up to $600,000 that each person ($1.2 million per married couple) is permitted to make to the recipient of his or her choice, free of the gift tax. We can bestow this $600,000 on anyone we like, or even someone we don't like--wife, husband, uncle, mother-in-law, Mike Milken, or General Motors, to help make up for that company's recent losses.

Meanwhile, every adult couple can give up to $20,000 annually to each of their children, also free of any gift tax. This opportunity is well- known, but many couples fail to take advantage of it, either because: (1) they worry that their children aren't mature enough to use the money wisely, or (2) they imagine they will go on living for a long time, and see no need to rush to sign over any of their assets.

Since it's simple enough to set up a trust fund for the children to delay their receipt of the money, thereby eliminating worry number one, my guess is that number two is the more likely cause of procrastination over making the $20,000 transfers by people who could easily afford them. This failure to act is very rewarding for the government, but unfortunate for the heirs.

This brings us to charitable contributions. Although corporations get most of the publicity for being charitable, individuals do most of the giving. In 1991, 89% of the $125 billion collected by churches, foundations, hospitals, schools, and the like came fro individuals. According to Nathan Weber of the Giving USA digest, we Americans spend more money every year on charity than we spend on gas and oil.

Our collective generosity is a wonderful thing, and continues to set us apart from certain societies of Scrooges in other parts of the world. Nevertheless, our charitable giving often comes in dribs and drabs out of the checkbook, with the major contributions left to the will. But there are more effective methods to consider.

Before you write the next sizable check to your favorite charity, you might want to review your portfolio to see if there are any securities that you could donate instead. Stock certificates can be signed over to any qualified tax-exempt organization, which in turn can sell the shares and pay no taxes on your gains. If you sold the shares yourself, you would owe the 28% capital gains tax, but by giving away the shares, you get their full value as a tax deduction. The advantages are even greater in states that have their own capital gains taxes.

Consider the following two scenarios. If you donate $5,000 to a worthy cause, and you happen to be in the highest tax bracket, you can save $1,550 on this year's income tax, so the donation ends up costing you $3,450. However, if you donate 1,000 shares of stock for which you paid $2,000 five years ago, but which are now worth $5,000, you avoid the $840 tax on the capital gain and you still get the $1,550 write-off against your taxable income. This way, the same $5,000 donation has cost you only $2,610.

I'm not a tax expert, but I'm told there are also advantages to donating artwork, jewelry, houses, used cars, and the like. Several national charities accept used cars in their "vehicle donation" programs. If you're giving away shares of stock, you must have owned them for a least a year and a day to get the full benefit of the tax breaks.

Before you give anything away, you ought to consult with your tax advisor. If you are subject to the alternative minimum tax, you'll have to make an adjustment for the size of the gift.

Until recently, the most effective way for an individual to contribute to charity has been through a foundation. But as I've discovered for myself, you pay a lot of legal fees to establish a foundation, and after that, you continue to pay the accountants for doing a great amount of paperwork. If Fidelity Investments had launched its Charitable Gift Fund a few years earlier, my wife and I could have avoided the bother.

This is my fifth column for Worth, and I haven't yet recommended a Fidelity product, so perhaps I can be allowed one plug for a Fidelity fund that permits small and large investors alike to

funnel money into worthy causes. At present, Fidelity is the only for-profit company that the IRS has approved to run a public charity, but various community foundations have set up similar operations.

You invest in the Charitable Gift Fund much in the same way you'd invest in a regular mutual fund. You make an initial contribution that is fully tax-deductible. A fund manager puts your money to work, and your assets grow tax-free. In the case of Fidelity's gift fund, you have the option of investing in a growth pool, an equity-income pool, or an interest- income pool, depending on your tolerance for the ups and downs of the stock market. You may also split investment of that gift between any of the funds. You can draw on your share of the assets by having the Gift Fund send checks (in amounts of $250 or more) to your favorite charities at any time.

Imagine that someday you'd like to do something special for the American Heart Association. So, you invest $10,000 in an equity mutual fund that grows at 10% a year, for 20 years. Assuming you deduct the amount needed to pay yearly taxes on the dividends, and then pay the capital gains tax on the profits when you get out of the fund, you will have turned your $10,000 into a $43,000 gift.

On the other hand, if you invest the same $10,000 in a Gift Fund account where it grows at 10% a year, but tax-free, your original $10,000 will produce a gift of more than $67,000. You see the advantage of tax-free compounding.

A technique I often use to inspire a charity to which I've contributed is the challenge grant. You offer them a donation of a specific amount, but only if they can match it by raising a similar amount from other sources. I've never met an organization that failed to match a challenge grant.

What begins with a donation may result in a larger involvement: a seat on the board, or a place on an ad hoc committee, or some similar opportunity to serve a worthy cause. In my own experience of working with charities, I've found that there's no job that's more rewarding.

CHARITABLE TRUSTS: SMART WAYS TO GIVE IT AWAY There are a few additional newfangled methods by which people can avoid estate taxes and maximize their charitable contributions.

Charitable remainder trust. You give a major asset (e.g., a portfolio of stocks) to a qualified charity. The stocks are sold, and the proceeds are put into a trust account that you've set up in advance. The trust is managed by the charity or an outside investment manager. You and your spouse continue to receive the income from the trust account for as long as you live. After you both die, the charity gets your trust account. This doesn't do your heirs any good, but if you don't have children, or if your children are richer than you are and don't need to inherit your money, there are tax advantages.

Pooled income fund. This is similar to the charitable remainder trust described above, except that your assets are put into a pooled fund run by the charity or an outside manager. Well-run funds

of this type can deliver the same returns as regular mutual funds. you can deduct about 25% to 50% of your donation, depending on your age and the fund's earnings history.

Charitable lead trust. This is a charitable remainder trust in reverse. You donate assets to a trust, the charity gets the income as long as you're alive, and when you die, the assets are handed over to your heirs. The more years the charity has use of the income, the bigger the tax break for your heirs.

Life estate agreement. You and your spouse sign over your house to charity and get a tax deduction for the present value of the remainder interest of the property. You can stay in the house for as long as you live. Then the charity takes possession.

Charity insurance. You take out a life insurance policy and name the charity of your choice as beneficiary. This enables you to give much more away than you could otherwise.

Charitable trust with insurance. Set up a charitable remainder trust and take out a life insurance policy that is equal to the value of the assets you've given to the trust. When you die, the assets in the trust become the property of the charity, but the life insurance pays off to the insurance trust, which in turn is distributed to your heirs. They pay less in taxes than they would if you simply willed your estate to them.

Gift annuity. These are offered by several financial services companies, colleges, and universities. You make a donation. The charity pays you a fixed return on your money, say 8% a year. You can arrange for payments to start immediately or later. The longer you delay, the greater your tax deduction may be. A 40-year-old who buys a fixed annuity that will start paying him income at age 65 can write off 90% of the value of the gift.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best- performing of all mutual funds over a 15-year period. He is a trustee of the Fidelity Group of Funds and his new book, Beating the Street, was published in March by Simon & Schuster.

KEYWORDS: benefactor, donate, real wealth

93/06-Of Betting on Biotech

By Peter Lynch

The recent collapse of the biotech group got me interested, as collapses almost always do. This isn't like the collapse of the saddle-making group, which never had a chance of coming back after the automobile was invented. Biogenetics has established itself as an industry of the future, as well as the bust of the present.

Knowing next to nothing about what goes on inside a biotech lab, I called a number of analysts and fund managers who specialize in this field. Here's the tantalizing part, as related to me by Stuart Weisbrod, a biotech analyst at Merrill Lynch. If, in early 1986, any of us had been smart enough to buy equal amounts of < wam-co NYSE:GNE>Genentech, Amgen, < wam-co NASD:CHIR>Chiron, Cetus (later acquired by Chiron), < wam-co NASD:BGEN>Biogen and Genex, we would have made 40% annually to the end of 1992, turning a $10,000 investment into $105,414 in spite of the fact that Genex went to zero. This is the sort of result that demands some attention.

Thirteen years ago, when the first of these companies began appearing on the stock exchanges, I remember hearing that all it took to start one was 100 PhDs, 101 microscopes, and $100 million in cash. The 101st microscope, I guess, was a spare. Or maybe there were 25 PhDs with 26 microscopes, but the story was always the same: The brilliant scientists were bound to hit upon a brilliant idea that could be turned into a useful product, from which the shareholders would someday make a tidy profit.

Speaking of tidy profits, the venture capitalists who put up the money to hire the PhDs and install the microscopes could "cash out" by selling all or part of their shares in an initial public offering. On Wall Street, this is called "harvesting the seed capital."

The original flurry of biotech issues I ignored, on the theory that mysterious ventures with no earnings should be avoided. I did buy some of the Genentech IPO, whose stock then rose from $35 to $89 on the first day of trading on October 14, 1980. This was a remarkable event, and a signal of exciting prospects to come. However, the biotech group accounted for less than .5% of Magellan's portfolio throughout the time I ran the fund.

A decade later, I'm hearing that the science of biotech has advanced rapidly. The pace of the research has quickened and the scientists are making more genetic breakthroughs than could have been imagined in 1980. Lately, they've been coming up with potential cures for many serious diseases.

Another thing that has advanced rapidly is the number of biotech companies whose shares are traded publicly. Instead of the handful of companies with the cash, the PhDs, and the microscopes that existed in 1980, there are now about 225, many added in the latest wave of public offerings that ended with the recent biotech slump.

Herein lies the problem, and the reason for the selloff. The odds are slim (I figure, 1,000 to 1 or so) that a great idea from one of the microscopes will ever become a saleable product. With all the companies

now involved in the business of developing new drugs, predicting which company's drug will be approved by the FDA is no easier than picking which turtle egg from a mess of turtle eggs will become a turtle and make it to the sea.

To usher a would-be saleable product through all three of the FDA's mandated trials can take from 5 to 15 years and cost from $100 million to $500 million. So far, the biotech group has been far more adept at inventing things than at surviving the dreaded three Phases, which are given roman numerals, like the Super Bowl.

In Phase I, the new substance is tested on from 20 to 100 patients to determine whether it's safe to use and isn't going to make people sicker than they already are. Then there's Phase II, involving between 50 and 250 patients, to show if the substance really works. After that comes the hard part, Phase III, the multi-center trials with up to several thousand patients, to show that the substance works in different surroundings.

What's been happening lately is that the new drug makes it through Phases I and II, and investors bid up the stock in anticipation of the final FDA approval (it's not uncommon for a biotech stock to double in value between one phase and another), and then the company flunks Phase III.

Earlier this year, Synergen flunked Phase III with its drug Antril, which treats septic shock, and the stock lost 68% of its value in one day--a fate that had previously befallen two other companies, XOMA and < wam-co NASD:CNTO>Centocor, that had developed similar drugs. It was once reported that "knowledgeable people" thought Centocor's Centoxin had a 90% to 95% chance of passing Phase III, which goes to show that a lot of knowledge can be a dangerous thing in the biotech field.

Moreover, when one biotech company fails a big test, the others are sold off in sympathy, as they were after Synergen's drug flopped last February. So many drugs have failed one test or another in recent years that between the end of 1991 and February 1993, the market value of the entire industry declined from about $41 billion to $26 billion, which reminds us how tenuous these valuations can be, based as they are on hopes and dreams, as opposed to earnings.

That's another problem: The earnings in biotech are as scarce as hen's teeth, which scientists have yet to invent. To date, only Genentech and Amgen have what could be called a tradition of meaningful earnings, although even Genentech's earnings have been highly variable, and Amgen didn't start making serious money until 1991. Others haven't fared as well. Genzyme earned a little something in 1991, as did Biogen in 1992, and Chiron, reportedly, is about to break even.

This, more or less, sums up the proceeds from the entire biotech group. Only about a dozen companies out of 225 have had products approved, and more than 90% of the companies in the biotech group are stuck in the "pre-revenue" stage, which is the new euphemism for not earning a living. The firms that can't make ends meet usually are absorbed into larger companies: That has happened to something like 75 companies since July 1990.

Apparently, the experts are as much in the dark about how to pick the next Genentech from among the many potential Genexes as the average person with a degree in English lit. I asked Linda Miller, an analyst at Paine Webber, if the PhDs with the microscopes have an advantage in choosing these stocks. She thinks not.

According to an article I read in Barron's, insiders at the Amgen labs, where ten molecules were being tested, were convinced that the least promising among them was the one that later became Epogen, Amgen's half- billion-dollar drug. Likewise, a product called Neupogen came out of nowhere and is now Amgen's second half-billion-dollar drug. So even the experts have trouble predicting these things.

Moreover, the success of an Epogen or a Neupogen depends on many factors outside the realm of science, such as what happens in the legal department (patent disputes are common in the industry) and what happens at the FDA. Many of the diseases that biotech companies are now trying to cure are difficult to test. It's hard to quantify how much better someone feels after taking a new genetically-produced arthritis medicine in Phase III.

Mr. Weisbrod's investment advice is to ignore the companies with the most exciting products, and buy the ones whose drugs have the best chance of getting approved. He saw the potential in Amgen quite early, because Neupogen did one simple thing that was easy to measure: It raised the white blood-cell count.

In the clinical trials, all Amgen had to prove was that people's white blood-cell count goes up after they take Neupogen. Synergen, on the other hand, had to prove that Antril helps people cope with septic shock, a more subjective exercise.

Every biotech analyst has a favorite method for separating the potential winners from the losers. Some concentrate on the cash, and pick companies with enough of a bankroll to survive several years at their current level of spending, which is called the "burn rate." Others look at the "M Score," which compares the level of R&D; spending with the total market value of the company. Others look for the number of products in the pipeline, or in Phases II and III. At present, these are only attempts to fathom the unfathomable.

The three most important lessons I've learned from my conversations are these: (1) Don't buy a biotech company because it announces an exciting new drug that hasn't yet been tested; (2) Don't assume that because an exciting drug has survived the first two trials, it's a shoo-in for Phase III; And (3) the investor's edge I'm always talking about often doesn't work in biotech. Investors who ignore these rules may end up getting nothing for something, as the shareholders of Genex already have.

Biotech reminds me of computers in the 1960s--the prospects in general are spectacular, but most of the prospectors are likely to fail. What a waste it is to understand the biotech potential, then put your money on the wrong company and lose it. Are there sensible ways to reduce the risks? That's the topic for my next column.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best- performing of all mutual funds over a 15-year period. He is vice chairman of Fidelity Management & Research Co. and has written a new book, Beating the Street, published by Simon & Schuster.

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93/08-A Chicken's Guide to Biotech

By Peter Lynch

In my last column, I discussed the perils of biotech investing, particularly in the small "start-up" companies over which much ado has been made, and often about nothing. For those who are still attracted to biotech, but not to the risks, there may be a chicken's way out.

Now that investors have lost faith and money in the recent biotech sell off, the 225 or so publicly traded companies in this industry can no longer depend on the public generosity to keep them solvent. In the past, when a biotech lab ran out of cash, it could always sell more shares to an eager crowd of buyers but not today. The new-issue market has all but shut down for lack of interest.

As a result, biotech companies that are low on cash are being forced to enter into mergers, joint ventures, or licensing agreements with richer partners, mostly the pharmaceutical giants. Thus, the new chicken's approach to investing in biotech: Buy the pharmaceutical giants.

For the drug companies, the chance to get involved with biotech couldn't have come at a better time. They've got problems that go far beyond Hillary Rodham Clinton. In the halcyon days of the 1980s (when even adjectives like halcyon were turned into drugs), the pharmaceutical giants went along happily increasing their earnings at an annual 12% to 20%. But lately, as many of the patents on their traditional best- selling drugs have expired (Cardizem, Procardia, Ceclor), they've run into fierce competition from the generics.

Now, as these traditional best-selling drugs are losing their money- making potency, new biotech products have emerged from the labs. Not only do these marvels of genetic engineering have the potential to cure many diseases that were incurable in the past, they also have the protection of new patents that won't expire for many years.

Every biotech analyst on Wall Street has a story about a pharmaceutical giant that will benefit from a biotech alliance. Stuart Weisbrod of < wam-co NYSE:MER>Merrill Lynch told me about Schering-Plough. It sounds like what happens when a tractor hits a rock, but Schering-Plough's a prosperous enterprise that's expected to earn $4.20 a share in 1993. It would earn 50 cents more but for the $125 million it spends annually on biotech R&D.;

In addition to this in-house research, Schering-Plough has a licensing agreement with Biogen to market alpha interferon, which has been highly profitable to date. Currently, Schering-Plough's stock is selling at about 15 times 1993 earnings, and the earnings are expected to continue to grow at a 15% rate. And another success from the biotech lab would speed that up.

Then there's Eli Lilly, which manufactures recombinant insulin in a joint venture with Genentech__Genentech getting an estimated 8% of the proceeds, Lilly the rest. Lilly is doing other joint ventures with Centocor. Meanwhile, Roche Holdings, the parent company of Hoffmann-La Roche, another pharmaceutical giant, has spent $2.1 billion to acquire 60% of Genentech. In similar fashion, American Home Products has acquired 67% of Genetics Institute.

American Home was given this opportunity after Genetics Institute lost an important patent suit to Amgen. Since then, the scientists at Genetics Institute have produced a blood- clotting protein by implanting a modified gene in the ovary cells of Chinese hamsters. How they think of these things is beyond me, but the result is a breakthrough in the treatment of hemophilia.

Genetics Institute is also pushing ahead with a family of cloned proteins that can repair bone cartilage and tissue, to take the place of tissue and bone transplants. Its blood cell work may revolutionize the treatment of infectious diseases. These could be very important developments for American Home, which all along has been doing something that even I can understand__raising its dividend for 41 years in a row.

Then there's a reverse chicken's approach to investing in biotech: Buy the biotech companies that are being absorbed by the pharmaceutical giants, or those that are involved in the major joint ventures. When a Roche spends billions to acquire 60% of Genentech's shares, it's a pretty good sign there's some value left in the remaining 40%. In fact, it was the announcement of Roche's plan to purchase a majority interest that convinced me that the biotech industry was for real.

This occurred in September of 1990. It took four months for Genentech stock to start its climb from $21 to $39. Roche still has the option to acquire all of Genentech's remaining shares, at a prearranged price well above the market, that increases each quarter. This gives the stock some built-in support. American Home Products has a similar arrangement with Genetics Institute.

Biotech companies that partially merge with the pharmaceutical giants have solved the liquidity problem that plagues their independent rivals, who are always scrambling around for more cash. To survive and to compete, a biotech company must have the wherewithal to support the scientists in the labs, then to pay for the clinical trials. Finally, if they do get an FDA approval, they may have to defend their ownership of the product when a rival biotech company claims it had developed the same thing first.

As it turns out, Biogen, Amgen, Genentech, and Genetics Institute are among a handful of biotech companies that have produced anything at all that's been approved by the FDA. Amgen, the most prosperous of the four, is beginning to resemble a pharmaceutical giant__an established enterprise with decent earnings from current products, and with potentially valuable new products in the pipeline. Last year, it earned $2.40 a share, or $358 million.

Amgen was recognized circa 1989 by Mike Gordon, Fidelity's biotech analyst at that time. Gordon was urging the in-house fund managers, including yours truly, to load up on the stock when it was selling in the $5 to $7 range. Later in 1989, when Amgen's first saleable compound, Epogen, got its final clearance from the FDA, the stock price had reached $10. At the end of 1991, the price had reached a high of $76. So in about two years, shareholders had made more than ten times their investment.

This lesson applies not only to biotech, but to investing in general: Just because the good news is already out doesn't mean it's too late to invest. While it's true that the biggest profits in biotech have been made from speculating in start-up companies and their untested ideas, Amgen's stock doubled again in 1991-92, after it had won all the patent battles over the Epogen compound.

Then, whacko, the entire biotech sector takes a fall because one other company fails an important clinical test, and Amgen's stock price drops with the rest, in sympathy. What had been a $70 stock is promptly marked down to $35, and Amgen the $10 billion company becomes Amgen the $5 billion company. An investor in biotech shares has to have a strong stomach and it helps to be farsighted as well.

It's times like these, when the entire biotech market has taken a hit, that brave investors can look for bargains, such as companies with share values close to their cash holdings. Of course, biotech companies can go through cash pretty quickly. However, limiting the search to companies that already have drugs on the market, or at least in clinical trials, and some revenues coming in will reduce some of the risk. (ImmuLogic Pharmaceutical Corp., for example, has allergy vaccines Catvax and Ragvax in the pipeline, a joint-venture agreement with Marion Merrell Dow, a joint R&D; project with Merck, $13.2 million in revenues, and has been selling for near its cash value for three months.)

For the average investor with a normal stomach who lacks the training to analyze a pharmaceutical giant and its biotech connections, the ultimate chicken's way out is to purchase a mutual fund. Although I spend much of my time telling people they can be successful stockpickers in almost any industry they follow, biotech is the exception. It's so volatile and so complex that it may make sense to let the pros do the picking. Your neighborhood investor's edge won't help you here.

At present count, there are 14 biotech-related funds on sale in the U.S. Most combine biotech stocks with health-care stocks, so the investor has only a partial exposure to biotech, although with all the complicated deals, it is getting harder to decide what a "pure" biotech investment might be.

The two funds that appear to have the most exposure to biotech are Fidelity's Select Biotechnology, managed by Karen Firestone, and Oppenheimer Global Bio-Tech, managed by Sandra Panem. Panem is far from your average stock jockey. She has a PhD in microbiology and once worked at the Brookings Institution in Washington writing on the economics of biotechnology. This is typical of the experts in this field, both the analysts and the fund managers, many of whom have multiple degrees. Weisbrod of Merrill Lynch also has a PhD in biochemistry and an MBA from Columbia; this is the kind of background a person needs before he can discuss ovary cells of Chinese hamsters as well as price-earnings ratios.

Two other biotech mutual funds are the closed-ended kind, which trade on the New York Stock Exchange. These are H&Q; Healthcare and H&Q; Life Sciences, both managed by Alan Carr at Hambrecht & Quist, hence, the H&Q; prefix. Carr thinks this is a good time to invest in biotech, now that the worry over health- care profits has driven down the prices of all related stocks, including the biotech issues, even though most don't have any profits.

At H&Q; Healthcare, Carr has put 42% of the fund's money into biotech. He is also investing some of that money as a venture capitalist would__to provide capital for biotech companies that have recently gotten started. With fewer venture capitalists investing in biotech these days, the mutual funds are beginning to play this role.

Let me leave you with this footnote:

Usually, my favorite method for investing in high-growth areas where the competition is fierce is the pan-and-shovel technique. This technique gets its name from the 19th century owners of general stores who got rich selling equipment to the prospectors who went bust in the Gold Rush. When I see a mania, such as computers, where dozens of companies are struggling to sell the same thing, I look for a supplier who provides them all with some basic gizmo they all need.

I never found such a company in biotech, but Stuart Weisbrod says there was one: Applied Biosystems. According to him, this was the best- performing stock in the whole group. Applied Biosystems made the DNA and protein synthesizers and other stuff used by all the biotech labs. It was a good stock until it was taken over by Perkin-Elmer, which unfortunately is too big a company to buy just for the Applied Biosystems part. It's uncanny how often the pan-and-shovel technique has worked.

Peter Lynch retired in 1990 from managing the Magellan Fund, the best-performing of all mutual funds over a 15-year period. He is a trustee of the Fidelity Group of funds and his new book, Beating the Street, was published in March by Simon & Schuster.

KEYWORDS: Mutual Funds Investing, Biotechnology Industry, Investing Strategies

93/09-What Goes Around...

One of the keys to Magellan's success was buying cyclical stocks in the early '80s. Is it time to buy cyclicals again?

By Peter Lynch

At Magellan, I loaded up on cyclical stocks during the 1981-1982 economic slump. This strategy was one of the keys to Magellan's success. It occurs to me that we may now be in a similar situation, one in which cyclical stocks will do well.

While the stock market overall has been stuck in the tightest trading range in 40 years, we've already seen some exciting advances in cyclicals. "Seen" may be the wrong verb, because many people seem not to have noticed the upturn, which is occurring, as usual, as we come out of the latest recession.

At the end of the glorious decade, the 1980s, the consumer growth stocks (Merck, Gillette, < wam-co NYSE:KO>Coca-Cola, Wal-Mart, < wam-co NYSE:HD>Home Depot__you know the names) continued to wax while the cyclicals waned, but this couldn't continue indefinitely. On Wall Street, what waxes today may wane tomorrow, as many of these growth stocks have, since 1991. Meanwhile, the cyclicals were due for a rebound.

Sure enough, the 30 companies included in Morgan Stanley's Cyclical Index turned in a 23 percent gain in 1992, when the S&P; 500 rose just 4.5 percent. In the first half of 1993, cyclicals once again have outpaced the average stock. One leader, Standard Products, which makes plastic and rubber gizmos for the transportation industry, has tripled off its 1990 bottom.

For those of you who haven't already heard, a cyclical is a company that will prosper in good times and suffer in bad. That's because it makes or sells expensive products or luxury items that customers can put off buying when they are short on cash. People continue to buy deodorant, dental floss, Big Macs, and headache pills no matter what, which is why drugstores and fast-food restaurants are not cyclicals.

Usually when people think of cyclicals, they think of the industrial giants, such as the steels, the aluminums, and the autos. But industrial giants no longer dominate the financial landscape the way they did in, say, the 1950s. The folks at Dow Jones have had to fill out the Dow Jones Industrials with such unlikely industrials as McDonald's and Disney. If more people realized that McDonald's was a Dow Jones Industrial, the Big Mac might not be so popular.

While the smokestack cyclicals have declined in number, there are other kinds of cyclicals, including some that are not recognized as such. Hotels are cyclical, since more rooms are sold, and at higher prices, in a strong economy. Expensive restaurants are cyclical, since they cater to a prosperous clientele, people who can retreat to the neighborhood bistro as soon as they feel the pinch of recession.

Machinery in general is cyclical, and so are the homebuilders, the appliance companies, and the furniture manufacturers. IBM turned into a cyclical when the mainframe computer became its most important product. Waste-management companies are cyclical__although when these clean-up stocks were widely touted some years ago, investors, unfortunately, did not recognize that fact. Many bought at the wrong time, only to see the cleanup stocks get clobbered in the recession. When business is slow, there's less waste to clean up.

Liner board, which we call cardboard, is cyclical; when nothing is selling, the stores don't need boxes to ship it in. Then there are the airlines. I regard United as the ultimate cyclical. One year it earns $15 a share, and another year it loses $15 a share. So it's a $15-a- share operation, no matter what.

If you're ever in doubt as to whether a certain company is a cyclical, the easiest way to tell is to look at its chart in Value Line, or in one of the chart books published by the Securities Research Company and available in libraries or in a broker's office. One of the lines on a stock chart is the earnings line, and here a picture is worth a thousand numbers. When the earnings line has a steady upward slope, the way Merck's does, you're dealing with a growth stock. When it wobbles up and down, as Alcoa's does, you're probably dealing with a cyclical.

The best time to get involved with cyclicals is when the economy is at its weakest, earnings are at their lowest, and public sentiment is at its bleakest. The staff at Standard & Poor's weekly newsletter, "The Outlook," once reviewed the eight recessions since World War II to find out what happened to the prices of key cyclical stocks after the stock market hit bottom. In every instance, the cyclical groups gained 50 percent or better in five months, more than double the advance of the S& P 500.

It is consumers who lead the way out of a recession, with their car buying and home buying and replacing of old appliances, all of which then creates a revival in the businesses up the line__lumber mills, steel plants, capital goods manufacturers, the advertisers, the newspapers that sell space to the advertisers, and so on.

Yet even though the cyclicals have rebounded in the same fashion eight times since World War II, buying them in the early stages of an economic recovery is never easy. Every recession brings out the skeptics who doubt that we will ever come out of it, and who predict that we will soon fall into a depression, when new cars will sit unsold in the showrooms forever and houses will stand empty, and the country will go bankrupt. If there's any time not to own cyclical stocks, it's in a depression.

"This one is different," is the doomsayer's litany, and, in fact, every recession is different, but that doesn't mean it's going to ruin us. In order not to get sucked into the gloom, I always remind myself that although we once suffered from chronic depressions leading to the Great Depression of 1929 (in fact, that one was no "greater" than several others), we are no longer the same economy.

Today 17 percent of Americans work for federal, state, or local governments, and millions more get Social Security benefits, unemployment compensation, and/or pension payments, so there are enough steady paychecks being cashed every week to keep the economy from slowing to a halt. We have a huge college industry and a huge health- care industry, both of which are immune from recession__colleges do better in recessions. There are many other stabilizing factors__the Fed, deposit insurance, and so forth__that we've all heard about.

This brings us to the ninth recession since World War II, which began in 1990. As usual, the skeptics said that this recession was different from other recessions, and that we might never recover from it. Now that we're two years into the recovery, some people are still doubting that we'll ever recover. Meanwhile, Europe is still in the depths of recession and Japan is sluggish, and the inevitable revival in both places will stimulate our economy.

While some cyclicals have produced impressive gains already, others have yet to turn, and if the experience of 1982 is any guide, the cyclicals have several good years ahead of them. Although Chrysler< /wam-co> has quadrupled in price since its 1990 low, and Ford has doubled, both stocks have barely reached the levels at which they sold before the Great Correction of 1987.

As business goes from lousy to mediocre, investors in cyclicals can make money; as it goes from mediocre to good, they can make money; from good to excellent, they may make a little more money, though not as much as before. It's when business goes from excellent back to good that investors begin to lose; from good to mediocre, they lose more; and from mediocre to lousy, they're back where they started.

So, you have to know where we are in the cycle, and right now, most companies are somewhere between lousy and mediocre. But it's not quite as simple as it sounds. Investing in cyclicals has become a game of anticipation, as large institutions try to get a jump on their competitors by buying cyclical companies before they've shown any signs of recovery. This can lead to false starts, when stock prices run up and then fall back with each contradictory statistic (we're recovering, we're not recovering) that is released.

To succeed at investing in cyclicals, you have to have some way of tracking the fundamentals of the industry and the company involved. This is where the Investor's Edge comes in. Of the 110 million Americans who have jobs, at least 50 million are involved in cyclical industries, where they are in a position to see a business turn before the news reaches Wall Street. People who build houses or sell houses, make cars or sell cars or parts of cars, work in a chemical plant or install aluminum siding, work in the airlines or the travel agencies, have a front-row seat from which they can watch the prices, the inventories, and the sales go up or down. Employees in the temporary-help agencies are the first to know which companies have more work than they can handle, a sure sign that business is getting better.

This is the sort of "inside information" that can be put to profitable use, although most people fail to take advantage of it. Even if you decide it's too late to buy your favorite cyclical in the current recovery, in the next five years, ten years, or 15 years there will be another down cycle, and another buying opportunity. Cyclicals are very forgiving. They always give you a second chance.

Peter Lynch writes the Investor's Edge column monthly. From 1977 through 1990 he managed the Magellan Fund, the best-performing of all mutual funds over a 15-year period, and he is now vice-chairman of Fidelity Management and Research Co. His latest book, Beating the Street, is published by Simon & Schuster.

KEYWORDS: Mutual Funds Investing, Stock Investing Strategies, Stock Market Trends

93/10-Investing on the House

By Peter Lynch

There's been a lot of sobering talk lately about housing and how instead of getting a big bounce in housing starts, we're only getting a hop. The "disappointing" housing numbers are used as evidence that the economic recovery has stalled.

I've been hearing a different story from David Berson and Mark Obrinsky, two of the resident experts at the Federal National Mortgage Association (Fannie Mae). While it's true that this year's estimated 1.27 million housing starts will fall far below the record of 2.4 million in 1972, Berson and Obrinsky estimate that 1.1 million single-family homes will be built in 1993. This almost reaches the all-time high of 1.2 million, set in 1986. Moreover, 3.8 million existing homes (the industry never calls them used homes) will change hands this year. This is also close to the all-time record of 4 million, set in 1978.

So we're in a strong phase for single-family construction and a boom in used-home sales, and housing in general is the most affordable it's been since the early '70s. The price of the median house continues to increase each year, as it has for the two and a half decades this data has been collected.

What hasn't bounced is multifamily housing, but that's not because we've been in a recession. The government has pulled its support for low- income housing and eliminated the tax shelters that created the boom in residential high-rises in the 1970s and early '80s. In 1972, there were 906,000 apartment buildings of five or more units built in the U.S., and last year there were only 139,000. It's this decline that makes the overall housing numbers look worse than they are.

Three years ago, I began to look into the housing sector, since housing is one of the first industries to turn around in a recovery. In the early stages, the home builders tend to do well, and home-building stocks made impressive gains from early 1991 to the end of 1992. The price of Toll Brothers, an East Coast builder that I often follow, increased more than fivefold.

Toll Brothers is a typical example of a company that will benefit from hard times. In the 1980s, anyone could build a house. All he needed was a tool kit, a nail apron, and a net to catch the money that bankers were throwing at the project. But in the bust years, banks will lend money only to established, well-capitalized builders. So builders like Toll emerge from the 1990 recession with as many new jobs as they can handle.

Nevertheless, by 1993, many of the home-building stocks had had a good run, and bargains were hard to find. The home builders may not be in the ninth inning of the recovery, but they surely have made it into the sixth or the seventh.

Whenever I research an industry, I like to call an assortment of Wall Street analysts to get their views on how various companies are doing. An analyst can be an invaluable resource, but you have to be careful about whom you listen to. I like the ones with proven records for staying up-to-date on each company they follow.

After talking to a couple of housing analysts, I found I was not alone in thinking it was hard to find bargains among the home builders. Greg Nejmeh at Lehman Brothers likes Lennar, a Florida builder that stands to benefit from Hurricane Andrew, and D.R. Horton, a newcomer that went public in 1992. But these are the exceptions.

From the stock picker's point of view, one of the nice things about a recovery is that it doesn't happen everywhere at once. So with the home builders already in recovery, I turned my attention to other companies in related industries that continue to struggle.

In the forestry group, John Chrysikopoulos at Goldman, Sachs likes Weyerhaeuser. Its timber sales have improved and will improve even more when Japan comes out of its recession, because Japan is a big buyer of U.S. trees. Its paper and packaging divisions are still in the doldrums, but eventually they'll prosper. Meanwhile, Weyerhaeuser has gone through the corporate Slim-Fast, selling an array of unrelated businesses to get back to solid wood.

The best thing that ever happened to timber companies such as Weyerhaeuser was the campaign to save the spotted owl. Who benefits when environmental groups successfully pressure the government to dramatically restrict the cutting of timber on federal lands? Firms with large private forests, including Weyerhaeuser, Georgia-Pacific, Louisiana-Pacific, and Plum Creek.

Plum Creek was spun off from Burlington Resources. It's a limited partnership (traded on the NYSE), and I've always been fond of publicly traded LPs. They require extra paperwork that scares a lot of investors away, and this creates bargains. Plum Creek has a decent balance sheet, strong cash flow, and no expenses to speak of. It's just a bunch of trees that the company harvests and sells, sending the proceeds to the shareholders as dividends.

The dividend fluctuates with profits, but at present the stock is yielding 7.7 percent. Since Plum Creek plants several new trees for every tree it cuts, there is an endless supply. This is a conservative's way to invest in lumber futures.

A few years ago I recommended Pier 1 Imports, on the theory that a housing revival is good news for home furnishers. Nobody wants to live in an empty house, and the new occupants have to have lamps, rugs, couches, and other such items that are sold at Pier 1.

Pier 1 has had its ups and downs, in part because the recovery in home furnishings is lagging the recovery in home sales. Perhaps home buyers have spent all their money and are holding off on decorating and renovations until they can replenish their bank accounts. But all the analysts with whom I spoke expect home furnishings and appliances to do well in 1994. Let's take a tour of the department store to find their favorite companies.

In the paint department--"coatings" on Wall Street--I heard nice things about Sherwin-Williams. This is one of those great companies in boring industries for which I'm always on the lookout. Paint is a pretty boring industry, but Sherwin-Williams has done a spectacular job, and the stock has been very exciting. The company has 2,000 outlets and opens 20 to 30 new stores each year, which is the slow-and-steady approach to growing a business. And when every U.S. town has a store, they can always move into Canada.

In the furniture department, John Baugh of Wheat, First Securities likes Heilig-Meyers, a retailer with 450 stores in 16 states. In the next five years, Heilig-Meyers plans to enter 19 more states. Their formula works, and they are taking it on the road, a la Wal-Mart. I learned from Wal-Mart and from McDonald's that successful companies can continue expanding for decades.

David Dwyer of Kidder likes Ethan Allen Interiors, the furniture maker spun out of INTERCO in 1989 that went public last March. The stock was $18 then and $19.50 now, so it hasn't gone far. Ethan Allen is famous for its Early American line, but half of what it makes today is contemporary. It earned $1.08 per share in the year ending in June, and Dwyer expects $1.45 next year and $1.75 by 1995.

I also got positive reviews on Pulaski Furniture, Winston Furniture (which went public at $16, then dropped to $10.50), Pier 1 (a stock I still like), and Leggett & Platt. L&P; is one of those wonderfully boring companies that makes a product that puts people to sleep: bedsprings. It has 50 percent of the bedspring market and is a major supplier of recliner parts for easy chairs and hide-a-beds. It has a great balance sheet and excellent earnings growth.

In the appliance department, Bob Cornell at Lehman Brothers likes Whirlpool, which makes 50 percent of the washer- dryers and 25 percent of the refrigerators in the U.S. This was a marginal company in the 1970s that has become a global leader in white goods. White goods is the industry term for large appliances; small appliances (TVs, microwaves, VCRs, radios, etc.) are known as brown goods.

In the carpet department, I discovered that while new carpets are superior to old ones (they are stain resistant and last longer), the price has stayed the same for many years. So carpeting is one area where the consumer is getting more for less, as opposed to, say, cars, where the prices are 80 percent higher than they were ten years ago.

Between laying down carpets in new buildings and replacing old carpets in old buildings (70 percent of the business is replacement), there's a steady demand for carpets. This should increase, because big fiber makers such as Dupont, Monsanto, and Allied are beginning to spend tens of millions to advertise the wonders of modern carpeting. Moreover, carpet making has become a highly mechanized industry in which the labor cost is only 10 percent of the price of the final product, so there is no threat of domestic carpet makers being undercut by foreign companies paying their workers 50 cents an hour.

Shaw Industries has been one of the all- time great stocks in history, number eight on the list of winners from the NYSE over the last decade. A $1,000 investment in Shaw in 1971 is worth $80,000 today. Shaw has succeeded by being a low-cost operator and by gobbling up many of its less efficient rivals. Today, Shaw makes 35 percent of all the carpets in the U.S., a remarkable figure. If they keep acquiring more competitors, Shaw will be making so many carpets that it may get a call from the antitrust division of the Justice Department, which probably has a Shaw carpet on its floor.

Shaw could continue to do well, but John Baugh of Wheat, First prefers < wam-co NASD:MOHK>Mohawk. Its stock price has more than doubled since Mohawk came public at $15. Citicorp owns a big chunk from the initial offering and hasn't sold a single share, which means that Citicorp must have a high opinion of Mohawk and its future prospects. Mohawk adopted the Shaw formula, but with only 7 percent of the market it has a lot more room to expand and acquire competitors.

That's the update on the housing sector. Housing is a cyclical industry, and the situation is always fluid. Right now, the best buys seem to be in companies that make the contents for houses, but the next time the stock market has a big correction, maybe the home-building stocks will sell off, and investors will have another chance to find bargains there.

Peter Lynch writes the Investor's Edge column monthly. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is now vice-chairman of Fidelity Management and Research Co. His latest book, Beating the Street, is published by Simon &Schuster.;

KEYWORDS: Stock Investing Strategies

93/11-Detroit's Comeback

While the Japanese downshift, investors can hitch a ride on the recovering U.S. automobile industry

By Peter Lynch

After a couple of years of improved car sales, a lot of people expected the party to be over, but as we've seen in the showrooms, the party continues, in spite of a sluggish economy that has added 2 million workers to the unemployment rolls since 1990. The public may not be buying new suits or dresses at the moment, but it is buying new cars.

In the car business, there are long stretches of poor sales, which create a so-called pent-up demand, followed by equally long stretches of excitement when the pent-up demand gets satisfied. These cycles of automotive boom and bust may be slightly out of sync with the economy at large.

One indication of how much pent-up demand exists at any given moment is the number of clunkers on the road. Right now, the average age of a car in the U.S. is 7.9 years, the highest it's been since 1948, when GIs home from the war had no money for anything but rent, diapers, and groceries.

Until somebody improves the bus service or invents a strap-on personal helicopter, most people will not tolerate living without a car. So as the clunkers conk out, they'll have to be replaced, and this means a steady supply of customers for car dealers and manufacturers.

This is happening at a time when the entire sad story of the U.S. auto industry in the late 1970s and early 1980s (inefficient, inept, insensitive to customers' needs) has been rewritten. Detroit is making good cars that people want to drive and that don't break down any more often than Japanese cars do. It's producing them in efficient factories that pay competitive wages.

The Japanese story (omniscient, omnipotent, omnivorous) has also been rewritten. When their economy was booming and their factories were running at top speed, the Japanese could sell their extra cars abroad at a very low cost per car. Today, with their factories running at half speed, the cost per car is much higher. Now it is Ford and not Toyota or Honda that is producing at full capacity. Now it is Japan and not Detroit that has to worry about losing its share of the U.S. market.

The financial press treats the decline in Japanese auto sales in the U.S. as though it's all to do with the rising yen and the falling dollar, which makes Japanese cars too pricey. This situation will reverse itself as soon as the yen falls and the dollar rises. I think more profound changes are at work here. The remarkable efforts of U.S. carmakers to correct their prior mistakes are likely to pay off for years to come.

In September 1992, I recommended Chrysler on Wall Street Week With Louis Rukeyser. Chrysler is doing okay selling cars and making a fortune on Jeeps and minivans. The minivan has replaced the station wagon as the suburbanite's favorite conveyance: It's roomier and also a better value. In the

government's dictionary, a minivan is defined as a truck, whereas a station wagon is a car. Being a truck exempts the minivan from certain emission-control requirements that add to the sticker price of cars.

Chrysler flirted with insolvency in the early 1980s, but today it is generating so much cash that the rating on its bonds is being raised from junk to investment grade. This would reduce its cost of borrowing and add further to its profits. Chrysler's Jeeps are selling well, and Chrysler has managed to hold on to a 50 percent share of the minivan market against a horde of competitors. The company has produced an exciting new line of cars (the LH series) in the $17,000 to $30,000 range and the first redesign of a full-size truck in 22 years. The Chrysler Neon, a lower-priced car that will appear at dealerships in 1994, has the potential appeal of GM's Saturn.

So it's easy to make a positive case for Chrysler, but with the stock having quadrupled in 24 months, it's not the buy it once was.

Three of the top auto analysts with whom I recently spoke (Wendy Beale- Needham at Smith Barney Shearson, Don DeScenza at DeScenza & Co., and David Bradley at J.P. Morgan Securities) like Chrysler, but they like < wam-co NYSE:GM>General Motors even better.

GM has long been the dunce of the industry--it took years for the company to figure out that customers actually want air bags in their cars--but lately GM has gotten smarter. It is installing air bags in all but three of its 1994 models. After noticing that many of its loyal Cadillac customers were getting too old to pass a driver's test, GM jazzed up the Caddy with a bigger engine to appeal to a younger crowd.

The main reason to prefer GM (and also Ford) over Chrysler is that GM and Ford have big overseas markets and will benefit when Europe shakes out of its recession, whereas Chrysler is essentially a domestic operation.

Elsewhere, I've noted that GM does so well with its non-automotive divisions, including GMAC, Hughes, and Electronic Data Systems (a canny acquisition it made from Ross Perot), that if it manages to break even on its U.S. auto business, it will make a fine profit. David Bradley thinks that before the end of the current upswing in car buying, GM can earn between $5 and $7 a share on U.S. car and truck sales alone. If that happens, the company's overall earnings would be $10 to $15 a share. He sees GM as a potential $100 stock.

GM may also benefit from the curious way Wall Street appraises the earnings of cyclical companies. Chrysler is doing better than GM at present, so let's say Chrysler earns $8, then $10, then $12 a share in the next three years, and in the fourth year it slips back to $10. Meanwhile, GM earns $4, $6, $8, and then the same $10 as Chrysler. At that point, investors are likely to pay more for GM's $10 than Chrysler's $10. That's because Chrysler will appear to have reached its peak, while GM will look like it's still climbing.

Supply-Side Investing: Besides the carmakers themselves, there are an estimated 2,500 additional companies whose principal products are parts of cars. Many of these are publicly traded, and they also stand to benefit from the surge in auto and truck sales. GM, Chrysler, Ford, and even the Japanese carmakers are manufacturing fewer parts in-house, and this "outsourcing" makes the parts industry more important than in any previous cycle.

Somewhere on a car or truck, there's always a part or two that will make investors happier than if they'd invested in the sum of the parts. The catalytic converter, antiskid brakes, and the air bag all have created big winners in the stock market, and so has the aluminum wheel.

The main supplier of aluminum wheels is Superior Industries, whose stock has enjoyed a modest 40-fold gain in a decade. It didn't take a Nostradamus to see this one coming. Carmakers had to reduce the weight of their cars to improve gas mileage to meet EPA standards, and they could drop an easy few pounds with aluminum wheels. The percentage of new cars and trucks with aluminum wheels has increased from zero 20 years ago to 37 at present count. Someday, it may be 100 percent.

There's a certain amount of protection in investing in an established supplier such as Superior. When a car part fails, it's the carmaker that gets the bad publicity and not the part maker, so carmakers are very careful about who gets the contract. A competitor might arrive with the best-looking aluminum wheel ever, but unless that competitor has a track record, carmakers aren't likely to give up on what already works.

Superior may have a prosperous future ahead of it, but the problem is that its price-to-earnings ratio of 34 already reflects that probability. If you want to invest in wheels, Wendy Beale-Needham suggests Hayes Wheels, a company that came public in 1992. Hayes is the largest supplier in Europe, and in North America it's number two, behind Superior. Varity, which sold the Hayes shares in the stock offering, still owns a sizable stake.

Don't Forget Spare Parts: The fact that 37 percent of the vehicles on the road are at least ten years old augurs well for the spare-parts business, also known as the aftermarket. The aftermarket has suffered in recent years because there were too many new cars on the road from the last big spurt in auto sales from 1983 to 1988.

In addition to normal cyclical blahs, two other factors added to the woes of the spare-parts market: Automakers insisted on making high- quality cars and trucks that refused to break down, and longer warranty periods meant that more repairs were being handled by dealers. But sooner or later, the warranties had to expire and the parts had to wear out. Millions of vehicles bought between 1983 and '88 have reached that age when they have to spend time in the shop.

So we can expect the aftermarket to become a very busy place--even busier if and when the other states follow California's lead in adopting stringent pollution-control standards. In addition, it's estimated that one third of all older cars will fail the EPA tests that go into effect in 1995.

Some of the best-known companies in this industry (Echlin, Standard Motor Products) have already seen their stocks rise in anticipation of better days ahead. Others have gone sideways, such as Genuine Parts, which went from $30 in 1987 to a recent $36. This company has increased earnings for 32 straight years, which puts it in the Lynch Hall of Fame. Even in the recent recession, Genuine Parts managed to boost its earnings. Lately, it's been cutting costs and upgrading the 700 NAPA parts stores it owns outright--it also supplies parts to 6,000 independent dealers. Don DeScenza has made Genuine Parts his number one pick in this sector.

Except for retailing and restaurants, there isn't another area of the stock market where more people have more of a chance to follow what's happening than in cars, trucks, and assorted parts. We'll eventually have an electric car, and once the initial confusion is sorted out, some company will emerge as the champion of that business, and we'll all realize who it is. Then there will be several champion suppliers of batteries and so forth, and we'll know who they are, too. And even though the news is out, there will be plenty of time to invest, because if Wall Street is true to form, it will be slow on the uptake.

Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is now vice-chairman of Fidelity Management and Research Co. His latest book, Beating the Street, is published by Simon &Schuster.;

KEYWORDS: Stock Investing

94/01-Prospecting in California

The worlds's seventh latgest economy is bottoming out. Get ready for the rebound.

By Peter Lynch

Recently, the decline and fall of California made the front page of the New York Times, in a three-part series, no less. It made me want to buy some California stocks.

The Decline and Fall of California bears an uncanny resemblance to the Decline and Fall of New England, which made the front page of the New York Times on July 23, 1990. In four years, New England had gone from economic miracle to economic disaster, and all the talk on the news was about the lost jobs and the death of the real estate market. You would have thought that Massachusetts, my home state, would have to be liquidated.

Now that New England has bounced back and Massachusetts is still in business, we can view the "disaster" with more dispassion. Housing prices never did collapse, except in the high end of the market, and even the fancy houses are selling again at somewhat fancy prices. People have cheered up and resumed shopping. The amazing part is, the recovery in New England has occurred without the jobs coming back.

The same sort of thing happened in Old England in the 1980s. The British economy looked so hopeless that people were delighted when it managed to muddle through. British stocks did brilliantly after that.

California in 1993 reminds me of New England in 1990 or Old England in the early '80s. Out of 14 million jobs in California, 560,000 have been lost, so that part of the disaster is hardly imaginary. But in the drumbeat of total despair--more layoffs in the defense industry are expected, for example--people are terrified that soon there will be no jobs left in the state.

Housing prices have declined in California, but mostly in the high-end houses, and after more than doubling in the 1980s they were due for a pullback. If what happened on the East Coast is repeated on the West, the California real estate market will stabilize as soon as there's a change in psychology. Then we'll see a modest rebound in consumer spending and a bigger rebound in the stock prices of a variety of California companies as investors anticipate a more prosperous future.

The New England psychology began to improve about the time our state government reduced its deficit and balanced its books. That's where California is right now. After several years of a double whammy--raising taxes and cutting the state payroll--the California government is about to balance its budget. The deficit has fallen from $2.6 billion in 1993 to a projected $560 million in 1994, and a zero deficit is projected for 1995.

I profited from New England's recovery by investing in regional banks and neighborhood savings and loans. Many were selling at tantalizing prices: below book value and with very low price-to-earnings ratios. Those with the wherewithal to survive have been remarkable performers. Problem loans have

declined, earnings have skyrocketed, and stock prices have doubled, tripled, and in a few cases quadrupled. All this in less than three years.

There's no reason to believe California S&Ls; won't follow the same script. As of this writing, half are selling below book value. I'm told by Joe Jolson, the S&L; analyst at Montgomery Securities in San Francisco, that for the first time in five years, California thrifts are able to sell their foreclosed real estate. The worst may be over for loan defaults.

In particular, Jolson likes SFFED, a stock that I recommended earlier this year. He also touts two lenders that specialize in California auto loans: CTL Credit, recently trading at $12.50, and Westcorp, trading at $10.50. These have been steady growers in a weak auto market that will benefit from a pickup in sales.

Other analysts are bullish on California's bigger thrifts, beginning with the nation's largest, H.F. Ahmanson, which writes 74 percent of its loans in California. Like its counterparts in New England, Ahmanson learned an expensive lesson and has been staying away from commercial real estate lately. The company recently unloaded another heap of trouble by selling $1.2 billion in delinquent single-family mortgages to Bear Stearns. This transaction may have broken all records for largest onetime disposal of bad home loans in modern financial history.

The drastic move will take a chunk out of Ahmanson's $19.50-a-share book value, but in the long run it will strengthen the company and prepare it for a huge boost in earnings later. Two other large S&Ls;, Great Western and Golden West Financial, also stand to benefit from a recovery in real estate. Golden West is so well managed it has avoided all trouble.

A slightly more far-fetched play on a California turnaround is Fannie Mae, my perennial favorite stock. While Fannie Mae has been a great investment--up twentyfold in nine years and more than fivefold in five-- the true value of the company is still not reflected in the price. Based on projected 1994 earnings, if Fannie Mae traded at the market multiple, it would be a $125 stock. But a cloud of doom always hangs over Fannie Mae, the way the cloud of dirt hangs over Pigpen.

People remember that Fannie Mae got hurt in the Texas recession, when battalions of homeowners walked away from their houses, defaulting on some Fannie Mae mortgages. Wall Street is worried that the same thing will happen in California, but I say it won't. Fannie Mae has tightened its underwriting standards since stubbing its toe in Texas. The delinquency rate on its mortgages has been going down for six years in a row, continuing to drop throughout the latest recession. Currently, the rate is less than six-tenths of one percent, a ten-year low. Meanwhile, Fannie Mae's mortgage-backed-securities business is booming.

In playing the New England recovery, I invested in a few retailers in addition to the banks and S&Ls;, but it was hard to find companies that were exclusive to the region. California is full of them. It has the seventh largest economy in the world and is home to a variety of businesses that derive most if not all of their revenues in-state. Thirty-one million Californians have a chance to monitor these companies firsthand.

The Good Guys is an electronics retailer with locations primarily in the Los Angeles and San Francisco areas. It offers excellent service and low prices, and the stock itself is selling at half its 1992 high of $22.50. The Good Guys will benefit when consumers resume shopping for nonessentials.

One grocery-store chain, Vons, operates almost exclusively in California, and a second, Albertson's, has a major presence in the state. Nordstrom< /wam-co>, a department-store chain based in Seattle, does 50 percent of its business in California, Dayton Hudson of Minneapolis gets 30 percent of its sales there, and Carter Hawley Hale, which just emerged from bankruptcy, does 90 percent of its sales in the state. Nordstrom is a well-managed company with a great record, and its stock has been trading at a below-market price-to-earnings ratio of 19.

California is also the land of the discount warehouse clubs. A majority of the Price Club outlets are located there, so Price Co. may benefit from a California turnaround, as well as from its recent merger with rival Costco. HomeBase, a West Coast version of Home Depot (owned by Waban< /wam-co>, which also operates the BJ's Wholesale Club in the East), has cloned itself around the state.

A discount retailer of a different kind that I've touted for two years running is Supercuts, a hair salon. One fourth of all Supercuts stores are found in California, and the recession may have helped their business, because people who can't afford the $100 stylist are coming in for the $13 shampoo and trim. Perhaps some of them will never return to the $100 stylist, but in any event, Supercuts is expanding across the country and its same-store sales are on the rise. The stock recently traded around $16.25.

Another way to profit from a turnaround in a depressed region or state is by acquiring shares in companies that own sizable parcels of real estate. During the go-go 1980s, raw land in California was priced so high it could have been sold by the ounce.

Today, there's a lot of land in California that's selling for a lot less than it was five years ago, and two publicly traded companies, Newhall Land and Farming and Tejon Ranch, have large inventories on the outskirts of Los Angeles. Newhall was a spectacular stock for two decades, and now it can be bought for half its 1989 high price.

This brings us to the California home builders. While the Decline and Fall gets most of the publicity, California has quietly become the best place in the country to build houses, with cheap land and a labor force willing to work for modest wages. Many former defense contractors are wielding hammers these days.

In the earlier recessions in Texas and New England, we've seen the marginal home builders go bankrupt, creating more business for the well- capitalized survivors. In California, the largest survivor is Kaufman & Broad (the Broad rhymes with toad, but the company is managed like the prince). Kaufman & Broad dominates the market for entry-level houses, and it plans to build several new communities in the next few years. It keeps costs low and quality high, a combination that's hard for competitors to beat.

While the New England recovery has been anemic, California's may be more robust. Its favorable location north of Mexico and at the gateway to the Far East, an impressive array of high-tech industries, and an experienced work force give California plenty of appeal.

If you miss the California recovery, don't despair. Sooner or later there will be another Decline and Fall, in the Sun Belt, perhaps, or in the Pacific Northwest, which already is slumping, or in Maryland and Virginia if we can ever lay off a few federal bureaucrats. When the calamity makes the front page of the Times, it's a signal to start your research.

Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

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94/02-Making a Bid for Sotheby's

With the art market finally regaining its strength, it's time to look at auction houses.

By Peter Lynch

Art may be the "window to the inner soul," but like cement or oil, it's also a commodity. It has its cycles of low prices and high prices and the occasional bubble followed by a bust. The latest bubble reached all the way to $82.5 million, the price fetched by Van Gogh's Portrait of Dr. Gachet in 1990. This, apparently, was the priciest bit of canvas ever unloaded at an auction. The art market was giddy. Soon afterward, it went into a three-year hangover.

What does art have to do with my favorite little objects of beauty-- stocks? When cement prices begin to turn up, it usually pays to own shares in cement companies. When aluminum prices begin to turn up, it usually pays to invest in Alcoa. So when Van Gogh prices turn up, I direct my attention to Sotheby's.

My idea of a great business is one that has a shortage of competitors. In America, we grow up thinking that competition is healthy, which in spelling bees, pie contests, and fund management, it is. But in such industries as airlines and computers, competition can lead to lousy earnings and multiple bankruptcies and is hazardous to human wealth. There ought to be a warning label.

Since any Tom, Dick, or Harriet can rent a room, buy a podium, hire a fast talker, and open business as an auction house, you'd figure that the auction business would be more competitive than even airlines or computers. This is not the case. Wealthy aristocrats, in particular, are very persnickety about who handles their effects. They want their auction houses to go back at least as far as their antiques. So they end up at one of two places: Sotheby's Holdings, founded in 1744, or Christie's International, founded in 1766.

These two companies, it turns out, handle 98 percent of the world's major auctions for art, antique furniture, jewelry, and other expensive items. Warren Buffett made his fortune and his reputation investing in companies that dominate their markets, from Katharine Graham's Washington Post to Rose Blumkin's furniture store in Omaha. Sotheby's and Christie's are like two Rose Blumkins, operating in 40 countries and 26 countries, respectively.

This isn't quite a monopoly, but a global duopoly is almost as good. You and I and $500 million could hire some scientists and invent a new computer chip, but we couldn't mount a serious threat against Sotheby's and Christie's. A company called Hapsburg Feldman recently tried and failed.

Sotheby's and Christie's have all the right contacts with galleries, dealers, and major museums. They employ celebrated experts in every category of fine art and collectibles, to whom curators at the major museums often turn for advice. Their representatives graze on the party circuit with the people who own expensive things. These are valuable long-term relationships that can't be manufactured more cheaply in Mexico or Taiwan.

That's not to say these two companies don't compete with each other. In its annual report, Sotheby's can't bring itself to mention Christie's by name. It refers only to "our main competitor." They fight endlessly over prestigious clients, and their rivalry is as spirited as the old Macy's versus Gimbels or Harvard versus Yale.

Last year, a resident of Paris, Hubert de Givenchy, announced he had decided to "simplify his lifestyle" by auctioning off several roomsful of bronzes, silver, rugs, and paintings from Louis XIV through the French Empire. A New York socialite reportedly tried to help Sotheby's win the Givenchy job with a clever seating arrangement. At a dinner party, she placed Givenchy next to Albert Taubman, Sotheby's chairman and principal stockholder, so the latter could schmooze the former. It didn't work. Christie's got the collection.

On the other hand, Sotheby's held the much-publicized auction of stuff from a castle belonging to Princess Gloria von Thurn und Taxis. This is not a German cab company. It's a prominent family whose tree reaches back into the Holy Roman Empire.

What makes this rivalry more amusing than damaging is that there are enough rich people to keep both auction houses very busy. Also, their squabbling over clients does not keep them from uniting on the important issue of raising prices. Late in 1992, Sotheby's upped its buyers' commission from 10 percent to 15 percent on the first $50,000 of any item purchased at its auctions. Christie's quickly followed suit. (Both houses take 10 percent of all amounts over $50,000.) If these were airlines, 15 other competitors would have forced them to lower their prices.

Even though the companies may be equally good investments, Sotheby's is located in New York and trades on the New York Stock Exchange, while London-based Christie's trades on the London Stock Exchange. That makes Sotheby's much easier to track for American investors. And being a Sotheby's shareholder myself, I follow that story more closely.

Sotheby's went public in 1977 with a small number of shares, only to be taken private again by Taubman in 1983. In spring of 1988, there was a new public offering of 11 million shares, a sizable chunk of which was supplied by Taubman. He made a lot of money on the sale, and the public ended up with a major stake in the auction house. The initial price was a split-adjusted $9 per share.

It was just before the Sotheby's IPO that artwork began to get preposterously expensive. First the Australian tycoon Alan Bond bought Van Gogh's Irises for $53 million. Then, shortly after the IPO, Picasso's Yo Picasso fetched $47.9 million. Eventually a Renoir entitled Au Moulin de la Gallette would go for $78.1 million. In the fall of 1989, Sotheby's stock peaked at the rather silly price of $37 a share, so for the initial investors, this was a four-bagger. The stock earned a record $1.96 per share.

It's in the nature of Wall Street to imagine that whenever a company sets a record for earnings, it will go on setting new ones. (This is no different from sports, where last year's winner is usually picked to repeat.) The people who paid $37 for the stock must have been looking for $2.50 in 1990 and $3-plus after that. They were unprepared for the expected: In cyclicals, a period of silly prices is followed by a period of sobriety. Sotheby's earnings dropped to 25 cents a share in 1991, and the $37 stock became a $10 stock. It's been stuck in the teens ever since.

This is unpleasant for former buyers, but it gives the rest of us a chance to own a piece of this great franchise at a reasonable price. Christie's peaked at almost $7 a share during the last bubble and has recently traded below $3.

During the decline, Sotheby's was strengthening itself. It cut its operating budget by 17.5 percent, to about $42 million. It reduced its debt from $54 million at the end of 1991 to $5 million by the end of 1992. As mentioned above, it raised the buyers' premium 50 percent. And it reduced its regular dividend.

Normally, I root for companies to increase the dividend, but not where the amount of the payout exceeds the annual earnings, as it did at Sotheby's for three years. This stock was artificially held up by the regular dividend, which, when cut last August from 15 cents per quarter to 6 cents, took away some of that support.

There are some risky elements to this business. To keep up its credibility in the art world, it must continue to employ the right experts (the recent resignation of president and CEO Michael Ainslie took Wall Street by surprise). Sotheby's may buy important artwork or furniture for its own account, hoping to resell these items at a profit; it could make a costly mistake. To attract prestigious collections to its auctions, Sotheby's sometimes offers the seller a guaranteed return. If the proceeds fall short of the guarantee, Sotheby's must make up the difference. And on the buyer's side, Sotheby's sometimes lends money to the winning bidder. When Alan Bond bought Irises, half the money he used was Sotheby's via a secured loan.

This loan caused a lot of head scratching after Bond went bankrupt and Sotheby's was left holding the Irises, which it later sold to the J. Paul Getty Museum

We can't have it both ways. If we believe sources that they recovered the difference, then of course it was resold for less.presumably for a much lower price. But sources in the company assure me that Sotheby's has recovered the balance of the loan from Bond and that the entire transaction turned out to be quite lucrative. Its finance subsidiary has become a profitable addition to the business.

So overall, this is a more attractive company than it was in 1989, selling for less than half the price while its principal commodity is showing signs of a revival. In December, Sotheby's sold 88 Picassos at an auction in New York, with most of the winning bids at the high end of the pre-auction estimates. Christie's had a successful fall season as well.

An auction buff myself, I recently attended a sale with my wife, Carolyn, at a leading local dealer in Boston. Here again, 90 percent of the paintings brought top dollar. An unsigned work, Still Life With Daffodils, was listed at $800 to $1,200 and went for $16,000. For a Sotheby's investor, this is exciting fundamental research.

There's also a growth element to this story, which adds to its appeal. The auction market itself is growing yearly at an estimated 15 percent worldwide, so Sotheby's stands to gain from that. The company has opened offices and "selling centers" in Europe, Latin America, and the Far East. In the 1980s, the Japanese traveled to auctions in New York to buy French art. Now they can attend auctions in

Japan and buy Japanese art. The Taiwanese can stay in Taiwan and buy Taiwanese art. The auction method seems to work in many cultures.

Sotheby's is also expanding its product line. Along with the furniture, antique jewelry, paintings, etc., Sotheby's is bringing many new items to the auction block: baseball cards, sports memorabilia, original sketches for Disney animated cartoons, comic books. The company now handles 70 different categories of collectibles. Through a subsidiary, it sells real estate, mostly in the seven-figure category. Its newest product? Used corporate jets.

Every decade seems to produce a different group of rich buyers who want to acquire the high-priced treasures of formerly rich sellers who need the cash (the Arabs in the 1970s, the Japanese in the 1980s). As long as there's death, divorce, changes of address, and reversals of fortune, we'll see no end to the procession of goods out of one drawing room and into another. Sotheby's will be there to collect the commissions both ways.

Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

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94/03-Company After My Own Heart

Unknown, unexciting, unheralded on Wall Street, and successful in Japan: What's not to like about AFLAC?

By Peter Lynch

AFLAC is my kind of company: a $15 billion operation most people know nothing about. Its main source of revenue is selling cancer insurance, which is unlikely to top any list of exciting businesses. Its headquarters is in Columbus, Georgia, which is at least one change of planes from Wall Street. The original name, American Family, was forgettable enough that in 1992 the board of directors voted to drop it in favor of the acronym. The longer and drawn-out version is the American Family Life Assurance Co. "Life assurance" sounds completely old-fashioned. It makes you think of a roomful of clerks sitting at high desks, making notations in giant ledgers with their quill pens.

But AFLAC is exciting where it counts. Its earnings have increased for 12 out of the past 13 years and continue to grow at a 15 percent annual clip. The stock has outperformed the market for 15 of the last 19 years in spite of the fact that it's chronically unfashionable and therefore undervalued. If you put a piece of tape over the name of the company and looked only at the earnings and the growth rate, you'd figure this to be a $37 to $40 stock in today's market. Since it's AFLAC, it's a $27 stock. A situation like this never bothers me. Stocks and singers may start out in the hinterlands, but if they keep making beautiful noises, they're bound to be discovered sooner or later.

In this case, the beautiful noises are in Japanese. AFLAC might just as well be named Japanese Family Life, or JAFLAC, in honor of its remarkable success in the country that has been the bugaboo of U.S. commerce. The Japanese won't buy U.S. products, you say? Twenty-eight million Japanese are insured by AFLAC. That's a quarter of the entire population. The only American-made product that has earned more money in Japan than AFLAC is Coca-Cola, also from Georgia.

To understand how this miracle happened, we have to go back to John Amos, a Colonel Sanders-ish character who got together with his two brothers to form the company on a shoestring budget in the 1950s. Their fledgling enterprise was nearly bankrupt when the Amos brothers revived it by dropping the general line of life insurance, which wasn't selling, in favor of cancer insurance.

Cancer insurance had its critics, who likened it to polio insurance and other "dread disease" coverage sold door-to-door to unsophisticated consumers at very high prices. What was a great deal for the insurers was often a lousy deal for the insured. Nevertheless, American Family earned a reputation for reliability and for paying its claims on time.

Through the 1950s and into the 1960s, American Family expanded its markets and prospered under the leadership of Amos. By the 1970s, when cancer insurance was no longer an easy sell in America, Amos took a pleasure trip to the Far East. I've always admired executives who don't let holidays interrupt their thinking. Some of the best ideas come from a relaxed brain. In this case, Amos was touring Japan with a

friend when he observed that the Japanese were obsessed with germs and preoccupied with cancer, which was both a leading cause of death and a taboo subject, just as it had been in the U.S. Meanwhile, they were madly puffing away on their cigarettes, so the surgeon general's warning hadn't quite caught up to them.

Investigating further, Amos discovered that Japanese salaries had increased to the point that millions of workers were wealthy enough to afford supplemental health insurance, and there were gaps in the national health system that might make such insurance desirable. In short, he realized he had stumbled onto the perfect market for the AFLAC cancer policy.

A family-run company such as this one can have its drawbacks, but one of the advantages is that there are no stodgy committees to pour cold water on a quirky yet fantastic idea. A committee might have pointed out that AFLAC had no contacts in Japan, no experience in doing business abroad, and no employees who spoke Japanese, and that larger U.S. companies with all three had failed to gain entry into that xenophobic country. Amos was not bothered by such trivial impediments. He came home and promptly filled out a formal application to the Japanese Ministry of Finance.

As it turns out, being small and unimportant worked in AFLAC's favor. It was hardly a threat to the Japanese insurance industry, since none of the Japanese insurers had any desire to sell cancer policies. That being the case, allowing AFLAC to operate in Japan was a painless way for the Japanese government to show its openness to U.S. business.

It still took four years of wrangling with the ministry before AFLAC was finally accepted into Japan. This was a lot like being accepted into an Ivy League college--difficult to do, but once you're there, the authorities will go to great lengths to prevent you from failing. Ergo, AFLAC was granted an eight-year monopoly on cancer insurance throughout the entire country. As if this weren't enough, it was allowed to sell its policies inside the major Japanese corporations, which agreed to encourage their workers to buy the insurance and to deduct the premiums automatically from the monthly paychecks. In this remarkable "sponsorship" system, retired executives from each corporation are often enlisted to do the actual selling. Imagine what it would mean to Aetna if General Electric offered to sponsor Aetna's policies in all its offices and factories, or to Travelers if Lee Iacocca returned to Chrysler to sell Travelers insurance to his former employees.

As of this writing, 92 percent of the corporations listed on the Tokyo Stock Exchange are involved in AFLAC sponsorships. Is it any wonder than in its first year in Japan, AFLAC had $25 million in sales, roughly eight times more than its most optimistic projections? Every year thereafter, the sales and revenues have grown, proving again and again that Amos's trip to Japan is the best thing that ever happened to the shareholders.

AFLAC could have followed the lead of many of the giants in the insurance industry by investing its policyholders' premiums in risky real estate loans and junk bonds. This was the thing to do in the 1980s, which resulted in many better-known insurers losing their shirts, along with their pants, shoes, cars, boats, and houses. AFLAC took a less sophisticated approach and put the money into boring old Treasury bonds, so today its $12 billion portfolio is one of the strongest and safest on earth. And since all its policies, Japanese or American, pay a lump-sum benefit, the company is not exposed to unlimited and unforeseen liability.

There are two bits of bad news in this story. AFLAC tried and failed to peddle its products in Australia, the United Kingdom, Italy and elsewhere. Apparently, nobody loves the cancer policy quite as much as the Japanese. And Americans don't love it as much as they used to, because by the mid-1980s, sales in the U.S. had begun to slow.

This was a transition period between the aging John Amos and his energetic nephew, Dan, who is now the CEO. Under Dan Amos, the company left the white-suit era and entered the gray-suit era. Among other things, the younger Amos installed modern management systems, improved and expanded the advertising, and launched a cost-cutting campaign that eliminated two of the four corporate jets.

Along with the internal makeover, the new leadership shut down operations in unprofitable foreign markets. They successfully introduced several new products into the U.S. market: accident, disability, nursing-home care, home health care, hospital indemnity and Medicare supplemental policies. In addition, AFLAC continues to own seven TV stations, which were acquired many years ago at almost no cost to the company, since the revenues covered the interest payments on the debt.

As the new products begin to pay off, cancer insurance is less important to the bottom line. In 1993, noncancer policies accounted for 68 percent of AFLAC's new domestic sales. Taking a lesson from its Japanese operations, AFLAC is selling these new policies through payroll deduction plans, to companies that range in size from 2 or 3 employees to 10,000.

Meanwhile, Japan is in a recession, and the sale of cancer policies has slowed even there. While there's still solid demand for the cancer coverage, AFLAC has begun to broaden the product line over there. It's introduced Super Cancer, an upgrade on the original, and Super Care, which helps defray nursing-home expenses for the elderly.

Nursing-home costs are a major concern in a country whose population is exceedingly long-lived, and Super Care has gotten a favorable reception to date. After one year of existence, it accounts for 25 percent of new sales in Japan.

AFLAC has been helped in recent years by the strength of the yen, since the bulk of its revenues come from people who pay their bills in yen. This could reverse itself at any time. A 10 percent drop in the value of the yen could take 15 cents off AFLAC's earnings per share and put a short-term drag on the growth rate.

But I'm convinced the long-term prospects are excellent. It costs a lot of money to bring new insurance products to market, and the big payoff comes several years down the road. Insurance companies are required to maintain sizable cash reserves for various contingencies. In Japan, AFLAC recently has reached the point where its reserves are fully funded, so it can now "repatriate" the surplus cash back to the parent company in the U.S. In 1993, it repatriated a record $100 million, a number that is almost certain to increase in 1994 and beyond. This extra cash may be used to buy back stock or raise the dividend, either of which would add to shareholder prosperity.

Even on the basis of 1993 earnings, AFLAC at $27 is a cheap U.S. stock with a price-to-earnings ratio of 12.9, as compared to the S&P; 500's price-to-earnings ratio of 22. Viewed as a Japanese stock, AFLAC is the biggest bargain in all of Tokyo. Give it a relatively low Japanese price-to-earnings multiple of 30 to

40, and in the current bear market these $27 shares suddenly become $70 to $90 shares. So if you've been searching in vain for a Japanese investment that isn't wildly overpriced, you haven't been looking in the right places. Try the New York Stock Exchange.

Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan Fund, the best performing of all mutual funds over a 15-year period, and he is a vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

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94/04-Bank On It

The author, perhaps the most famous stock picker ever, tells how to profit from one of the best opportunities he has witnessed during a 30- year career of beating Wall Street

By Peter Lynch

My first column for Worth appeared in the August/September 1992 issue. The subject was the great investment opportunities in the scores of mutual savings banks and thrifts (a.k.a. savings and loans that were going public). Perhaps you know what's happened since then: The share prices of many of these new public companies have doubled, tripled, and even quadrupled in the period following the initial offerings. In my 30 years of looking at stocks, I've rarely seen a group do as well as this one has.

During good times for packaged foods, insurance, or retailers, not every food packager, insurance company, or retailer is going to share in the prosperity. An investor may find the right sector but choose the wrong stock and lose money. But among the mutual savings banks, it's hard to find a wrong stock. Of the 13 that began trading in 1991, the worst performer is up 89 percent.(For more on that year's conversions, see "Class of 1991" on this page.) Out of 46 new issues in 1992, there's only one loser to date. And of the 57 initial offerings in 1993, there are no losers; 30 have gained more than 30 percent.

I'm not telling this old story to exercise my hindsight--who cares about the wonderful investments we all might have made in years past? What causes me to revisit the topic is the 1,231 mutual savings banks that haven't yet converted to public ownership. On top of those, a sizable number of prior converts are trading in the market at bargain prices.

The savings banks have recently made headlines, but not the kind I'd like to see. It seems that a small number of officers and directors have been enriching themselves on their own conversions by issuing themselves free shares or options to buy shares at a discount. There's a move afoot in Congress to put a stop to the insiders' profiteering, and the Office of Thrift Supervision has slapped a moratorium on all future deals while it studies the matter. Meanwhile, the Treasury Department has halted all direct sales of savings banks to larger commercial banks.

I'm no fan of insiders getting more than they deserve. If that's the situation, it ought to be corrected. But to my mind, the prospering of insiders is not the biggest tragedy with conversions. The biggest tragedy is that millions of depositors, average people with CDs or savings accounts, also could have prospered but have not. When given the chance to participate in the scores of recent offerings, only 2 percent of the depositors have taken advantage. The rest have turned down what may be the opportunity of a lifetime.

My guess is that this moratorium on thrift conversions will be lifted sooner or later. Some way has to be found to bring the remaining mutuals into the system of public ownership, or else they'll be unable to compete with the other banks and thrifts that enjoy access to public capital. And unless the rules are drastically revised in the wrong direction, there will be more good deals to come. I only hope that more individuals will enjoy the benefits.

So we know what we're taking about here, mutual savings banks, thrifts, and savings and loans are varieties of the same species. Some are chartered by the states and others by the federal government. Many began in the 19th century as neighborhood associations, similar to electric co-ops or food co-ops. They aren't owned by anyone in particular, except the mass of depositors. This mass ownership is what creates a windfall for the new shareholders, as I'll explain in more detail below.

It's ironic that mutual-savings-bank conversions are branded in the press as unfair to the little guy. Actually, conversions are the rare exception where the little guy gets to buy shares at the initial offering price. In nearly any other kind of IPO, the Wall Street gorillas (institutions, mutual funds) grab all the shares, while the average person is shut out. I often wonder why we bother to call these events public offerings at all; generally, the public has nothing to do with them.

But the offerings of savings banks are truly democratic. Widows, blue- collar workers, and kids with paper routes get a crack at the shares. Although the actual requirements for conversion vesting (that is, eligibility for buying shares at conversion) vary from bank to bank, in most cases a passbook balance of $100 to $500 will give you the right to purchase as much stock as you can afford, up to several hundred thousand dollars' worth.

When a savings bank decides to convert, one of the first things it does is send out letters to all depositors informing them of these rights. Most of these letters, and most of the announcements that follow, end up in the trash along with the junk mail. People are used to getting toaster ovens and calendars from banks--not stock solicitations. They think there's something fishy about a bank's inviting them to put up money in advance to buy its own shares. They've all read the stories about Charles Keating.

This rejection by its own customers usually forces the bank to extend its offer to an ever-widening group of outsiders: residents of the county, residents of neighboring counties, or even all residents of the state. Some of the shares will end up in the hands of professional investors like me who open accounts in a variety of banks and thrifts with the sole purpose of hitting upon a possible conversion. I know about this from personal experience. Seven years ago, my wife, Carolyn, and I bought CDs in several different mutuals in our vicinity.

Becoming a serial depositor is not everybody's idea of an exciting time, and keeping track of the paperwork can be a minor hassle. On the plus side, it only takes one conversion to make all your troubles worthwhile. We have been fortunate enough to have stumbled into four: three in the area around greater Boston, where we live, and one in Maine, where the family goes skiing. Given the remarkable performance of so many other conversions around the country, I only wish we had spent the latter part of the 1980s traveling from coast to coast, sticking money into thrifts.

On second thought, the kids would have mutinied in the back seat. Anyway, the vesting requirements have been tightened to discourage the long-distance carpetbaggers. That's just as well. I'm all for keeping the profits in the neighborhood where savings banks are located, and with 1,231 possible conversions waiting to happen, the odds are excellent that at least one candidate can be found in a city or town where you live or work.

It can't hurt to ask local bankers how many unconverted thrifts exist in your area. Leave a small deposit or purchase a small CD in each one, and even if nothing happens, you'll collect your interest payments. The 100 most likely and most attractive candidates for conversion are identified in "Get Ready," a list that comes courtesy of SNL Securities, a highly regarded advisory service in Charlottesville, Virginia. There are opportunities here in 32 different states. Shown in italics are the 29 thrifts that SNL predicts are most likely to convert within two years. No guarantees, of course.

CASH IN THE TILL

What makes conversions such exceptional investments? It's not simply the bull market that has lifted these stocks. It's the fact that mutual savings banks have no formal owners. A normal company has founders, early investors, and venture capitalists, all of whom claim a share of the proceeds from a stock sale when the company goes public. But a mutual savings bank has only depositors. There are no sellers to compensate. Officers and directors may get free stock, as we've noted, but all the cash that's raised in the offering, minus the underwriting fee, is returned to the company till.

The effect is quite magical. Let's say PennyWise Mutual Savings Bank, which has a net worth of $10 million before conversion, announces a public offering: 1 million shares at $10 per share. The underwriters take their small cut, but for the sake of this exercise, we'll ignore that. So the entire proceeds of $10 million revert to PennyWise. This doubles the value of the company, from $10 million to $20 million. The lucky buyers have just paid $10 million for a $20 million property. Another way of looking at it is they've bought the company for zero.

It's hard to think of another transaction where the value of the merchandise doubles the minute it changes hands. Imagine it this way. You've just paid $10,000 in cash for a new car and driven it home, where you open the glove compartment and discover your $10,000 has been placed there, along with a note from the car dealer: "We don't need this. You keep it."

As long as you leave that money in the glove compartment, your $10,000 car is a lot more valuable than it was before you bought it. Is it any wonder then, that the stock price of a mutual savings bank rises quickly as soon as it starts trading on the open market? Indeed, first-day gains average more than 30 percent. For depositors who are used to getting 3 percent on their CDs, that's ten years' worth of interest, paid overnight. The initial price surge is usually followed by a second, more gradual increase. On average, the 384 thrifts that trade on the major exchanges sell for 104 percent of book value in today's market. Usually, it takes the newer conversions several months or even years to reach this plateau. Investors who miss out on the quick 30 percent profit from the offering can get in on the next 50-70 percent by purchasing shares later.

The example of Green Point Savings is instructive. This is the New York bank (publicly trading as its parent, GP Financial) that was at the center of the fuss about the insiders' unfair advantage. The original plan was to sell Green Point to Republic New York Corp., and when that deal didn't pan out, the directors decided to take their bank public. In typical fashion, the stock was offered at $15 and quickly rose to about $20, where as of this writing it now sits. The book value is $27, and if the earlier pattern holds, the price will creep up to that level eventually.

But let me repeat myself: no guarantees. In spite of the built-in advantage of cash in the drawer, it's a mistake to think that one savings bank is as good as another. Some are highly profitable, others less. Some have "clean" loan portfolios; others are plagued with defaults and foreclosures. While most are solvent, a few of the shaky ones are forced into conversion by the government so they can meet minimal capital requirements with the infusion of new money. These so- called supervisory conversions can be hazardous to investors. I wouldn't invest in any thrift without asking some basic questions.

-- Is there enough equity? Equity is important for two reasons. If a bank lacks sufficient equity, it puts itself in a precarious situation with regulators and becomes a candidate for bailout or liquidation. The S&L; casualties of the 1980s didn't have enough equity to cover the losses from bad loans.

The proceeds from a public offering are counted as equity, which is why converted savings banks excel in this category. The equity-to-assets ratio is the standard measure of financial strength, and an e/a of 5 percent is considered good. J.P. Morgan, one of the nation's strongest commercial banks, has an e/a of 7, while the average e/a of the 384 publicly traded thrifts is 9 percent. Green Point Savings has 20 percent equity to assets after adding the new capital from the conversion.

A couple good things can happen to a bank that's cash rich. The more equity it has, the more loans it can make; the more loans it makes, the more it increases its earnings.

Or if it doesn't want to make loans, it can invest the money in Treasury bills and earn a nice living. Better yet, it can buy back its own stock. Fewer shares outstanding means more earnings per share, more book value per share, and a higher stock price.

-- Is there a high-quality portfolio of loans? Bad loans, a.k.a. nonperforming assets, can break a bank very quickly as it channels more money into its loss reserves and into the management of properties in foreclosure. I look for thrifts that have a low percentage of nonperformers. Less than 0.5 percent is comforting.

-- Is the thrift making money? The common measure of a bank's profitability is return on assets. You get the ROA by dividing the bank's income by its assets over a specified period. A 1 percent ROA is average, and that's a good benchmark to use. Anything above that is a plus. Another useful measure is the price-to-earnings ratio. I look for thrifts with p/e ratios below 10. I'd be wary of investing in any thrift that is losing money (zero or negative earnings) at the time it goes public.

-- What's the book value? You can get this number from a bank officer, the investor-relations department (if there is one), an annual report, an S&P; report, or a variety of other research services. Its importance has already been noted.

If bank officers have begun the conversion process, your investigation is a snap: Everything you need to know can be found in the prospectus. Here, you'll find the offering price of the stock, the earnings history, the makeup of the loan portfolio, the percentage of nonperforming assets, the equity-to-assets ratio, the resumes of officers and directors, the number of shares they are buying, and at what price. This last detail is an important one. Corporate insiders are not known to be self-destructive. They don't buy company stock unless they expect to make money on it. So when you pay the same price they do, you're in with the right crowd.

I also look for a couple of other things. If a bank owns its own branches, it's a plus. Real estate is carried on the books at cost and can be a valuable hidden asset. Another plus is what bankers call cheap deposits. A bank that has few branches and large concentrations of deposits tends to be more cost effective than one with many branches and smaller deposits.

After you've read the prospectus, you can ask all the questions you want and clear up any remaining confusion at a meeting with bank officers and others in the know, to which every would-be investor is invited. The hosts will probably serve donuts and coffee or sandwiches and Coke, and still only six or eight people will show up. This is another rare opportunity for the average person to learn from the horse's mouth--and it's astounding how few take advantage. They're too busy listening to their brokers and watching for the latest hot tip from CNBC.

WINNERS AND LOSERS

What can we learn from 2 savings banks out of the 116 that converted since 1991 whose share prices have lagged behind the rest? The biggest disappointment is First Federal Savings & Loan Association of San Bernardino, which at this point is the only outright loser in the group. It has suffered from being in the wrong place at the wrong time: California in its worst recession in the modern era. The other disappointment, although not a loser at the moment, is < wam-co NASD:PTRS>Potters S&L; of East Liverpool, Ohio. Potters's stock followed the usual pattern--it was offered at $10 a share in 1993, then jumped to $10.88 on the open market. But from there, it drifted downward, reaching a low of about $9. However, it rebounded and today it sells for around $11.

Maybe Potters is jinxed by having virtually the same name as the villainous banker in It's a Wonderful Life. But from what I can gather, the basic problem is earnings. Potters wasn't making much money when it converted, and it's barely profitable today. With 6 percent nonperforming assets, it's not hard to imagine where the profits have gone.

Anyone who asked the key questions about Potters would have avoided the stock. It flunked the test on loan quality. Until you get hard evidence that the delinquency rate is in decline, you're better off putting your money elsewhere. There's plenty of opportunity.

In the column I wrote on this subject in 1992, I included a list of ten savings banks with favorable characteristics. That group is up some 58 percent (see "Scorecard"). A new list of good candidates appears in "Prospects." I'm not suggesting that you run out and buy these, only that they appear to be worth consideration. (I personally own many thrifts including three on this list: Pamrapo , Fidelity New York, and North Side Bank.) Investigate before you invest.

Another word of warning: The perfect conditions banks have enjoyed for several years won't last forever. It's been an extremely happy time for bankers, something they can tell the grandchildren about: declining interest rates, an accommodating Federal Reserve, an improving economy, and a beautifully shaped yield curve. With short rates low and long rates high, a banker can lend money at 6 percent, borrow at 3 percent, and feast on the spread.

Eventually we will have another period of tight money. The first tiny increase in the Fed's lending rate in early February caused bank stocks to stumble. Rising interest rates are profit killers. During 1.5 years out of every 10, on average, we get an inverted yield curve, when short rates are high and long rates are low. This is a calamity for banks.

So it may be that the steady upward rise in bank stock prices will be interrupted sooner or later. But long-term there's another reason to be bullish: consolidation.

In the past five years, nearly 37 percent of the thrifts and savings banks have been acquired through mergers and buyouts. When this happens, the stock prices are pushed to a third tier, far above book value.

Even with the buyouts temporarily put on hold, consolidation is inevitable because we have too many deposit takers in this country. If you count credit unions there are more than 20,000 separate institutions where we can park our money. Each one has its own advertising jingle, board of directors, auditors, software system, and headquarters. The last time I wrote about this, I mentioned the six banks in my town of 19,000 people, as compared to nine in all of Canada. My little town still has six banks.

The record levels of cash that has piled up in the commercial banks is another stimulus to mergers. The industry today looks like it did after World War II--bankers have more cash than they've seen in decades and no place to lend it. By acquiring smaller banks and thrifts, they can expand their deposit bases and eventually increase their earnings.

So we're seeing a double trend: Many mutual savings banks and thrifts are going public, while others are being bought out. Many of the takeover targets are attractive to larger institutions because they, too, are full of cash. On our list of good prospects, Queens County, Pamrapo, and Sunrise Federal can be put in the cash-rich category, along with Green Point, with its incredible 20 percent equity-to-assets ratio.

You may have noticed that seven of the banks on the recommended list are from New York and three from California. On the last list, two were from New England. I've always found the biggest bargains in the thrift group in regions that are recovering from recession. But you have to be careful to buy the ones where loan delinquencies are in decline, and where the situation--the health of both the bank and the community or region--is getting better and not worse.

New York banks are especially ripe for takeover, because the regulations in New York make it easy for out-of-state banks to make acquisitions. Wherever these takeovers have occurred, the target has been bought out at a premium to book value.

SNL Securities (these people keep themselves very busy) did a recent study of the 16 thrifts acquired by larger institutions in 1993. The average acquisition price was 1.5 times book. Not a single one was acquired at a price less than 300 percent of the initial offering price for the shares.

By this measure, our fictional PennyWise, which went public at $10 with a $20 book value, would be worth $30 in a takeover. Of the three phases in the life of a mutual savings bank or thrift, this last one is the most rewarding of all.

Ask the residents of Hattiesburg, Mississippi; Wilmington, North Carolina; Bay City, Missouri; Lakewood, Colorado; New Smyrna Beach, Florida; Covington, Kentucky; or Hometown, La Grange, and Tinley Park, Illinois. They've already tripled their money by investing in the places where they cash their paychecks. That's my kind of insider's edge.

KEYWORDS: Banking Industry, Stock Investing Strategies

94/05-Charlie Silk's 150-Bagger

Meet an amateur investor with an approach -- and a track record -- any professional would be proud of

By Peter Lynch

My candidate for the world's greatest amateur investor is Charles Silk. I met this fellow Bostonian halfway around the world, at a reception at the Bible Lands Museum in Jersualem in 1992. We were part of a trade mission to Israel sponsored by the state of Massachusetts. It turned out we had a few friends and many stocks in common. On a bus ride to historic sites, we had our first extended chat. Not about historic sites, but about Blockbuster Entertainment, Charlie's most successful pick.

Charlie bought Blockbuster many splits ago, in 1984, for $3 a share. It wasn't called Blockbuster yet. It was called Cook Data Services, which fit into Charlie's area of expertise. He had had his own data-processing company, which had fallen on hard times, and he was forced to shut it down. He was sitting home, doing telemarketing for a software outfit and wishing he could find another way to make a living.

Cook Data Services solved his problem. The shares he bought for $3 apiece are worth $450 today, so his $10,000 investment became a living in itself. Thanks to this one exciting stock, he was able to abandon telemarketing and devote himself to his favorite hobby--looking for more exciting stocks. He and two of his three sons are now full-time stock pickers.

I've often said that a couple five-baggers every decade is enough to make do-it-yourself investing a worthwhile pastime. With a 150-bagger like Cook Data, one every half century or so is all anybody needs.

Call Charlie a lucky man for stumbling onto Cook Data Services, but luck didn't make him a millionaire. The hard part was holding on to the stock long enough to get the full benefit. After the price had doubled and then tripled, he didn't say to himself, I'll take my profits and run, like many investors who invent arbitrary rules for when to sell. He wasn't scared out when the price dropped, as it did several times, and he ignored the highly publicized negative comments made by forecasters and "experts" who knew less about Blockbuster than he did. He had the discipline to hold on as long as the fundamentals of the company were favorable. It was not a guess on his part. He was doing his homework all along.

In my investing career, the best gains usually have come in the third or fourth year, not in the third or fourth week or the third or fourth month. It took eight years for Charlie to get his 150-bagger, but in a way, he'd been preparing for the opportunity since college.

At the University of Michigan, where he earned a degree in accounting and finance, Charlie was first exposed to one of life's great mysteries: How do you find a good stock? A professor named Wilford J. Eiteman, famous at the time for his market theories, posed the question. Over the years, Charlie found his own answer. He searches for good stocks among small companies that are relatively debt free and have been beaten down in the market, to the point that they're selling for less than the cash in their bank accounts. "I'm paying nothing for the company itself," Charlie says in his rich Boston accent. "The only thing I'm risking is my patience."

He reminds us that on the New York Stock Exchange, 70 percent of the companies are followed by two or more analysts, but on Nasdaq, 72 percent are not covered by any analysts. This lack of coverage helps produce the great distortions between price and value that he seeks out.

Beginning in the 1960s, Charlie combed the so-called pink sheets in the over-the-counter market. Many small companies went public in the hot initial-public-offerings market late in the decade only to see their prices collapse in the 1973-74 bear market. But it was a heyday for Charlie. Roaming through the wreckage, he found several low-risk opportunities in the area he understood: computers and data processing. A company called Computer Usage had $4.10 a share in cash; he bought the stock for $2.25. Another was Scientific Computers, which had $1.37 a share in cash and at one point was selling for 25 cents. On the rebound, it hit a high of $33.50, but Charlie had bailed out at about $6. "I learned then how tricky it is to know when to sell," he says.

Now we move forward to 1984. Another hot IPO market was followed by a collapse at the end of that year. Small high-tech stocks suffered the most. For Charlie, it was 1974 all over again, except this time he didn't have to bother with pink sheets. Nasdaq had launched its computerized trading system.

He surveyed this latest wreckage. Cook Data Services caught his eye. It sold software programs to oil and gas companies--right up Charlie's alley. It came public in 1983 at $16 a share and quickly rose to $21.50, but the price had fallen to $8 when Charlie began tracking it. He was still tracking when year-end selling dropped the price to $3.

This was the kind of risk Charlie liked to take: a company with no debt and $4 a share in cash, selling for $3. But cash in itself is no guarantee of success. If a company is sick to begin with, it has to spend its cash to stay alive. Cook Data was quite healthy. Its revenues had increased four years in a row. "To produce a record like that," Charlie says, "they had to have something on the ball." His $10,000 investment was as much as he could scrape up. It made him one of the largest shareholders.

A few months after Charlie bought his shares, Cook Data announced it was moving away from data services and into the "consumer area." The company's president, David Cook, had an ex-wife who was a movie buff. Apparently, she still had some influence and convinced him to open a video superstore in Dallas.

Charlie wanted to know more. He got some of his best information by calling the company directly. He made contact with the CEO, Ken Anderson, and also with the investor-relations person, Barbara Phelps. She agreed to send him articles about Cook Data that appeared in the Dallas newspapers.

One of the most interesting things the company sent Charlie was an independent study on the future of the video-rental industry. "When I read that thing," Charlie says, "I found out that 30 percent of American households owned VCRs, and that eventually 60-70 percent would own these machines. [This estimate turned out to be conservative.] All these millions of people with VCRs were going to need an endless supply of tapes."

It got more interesting when he went to the library and looked up company filings in the SEC's Official Summary of Security Transactions and Holdings. He saw that two different groups, the Sanchezes from Texas and Scott and Lawrence Beck from Illinois, had become major shareholders. Scott Beck was

coauthor of the video study and obviously impressed by his own research. Charlie also learned that revenues from the Dallas superstore had more than doubled in the first three months of operation. His sources at the company confirmed these numbers and told him how crowded the store was. It was amazing, they said. People were driving from as far as 30 miles away.

Meanwhile, the stock price had begun to rise on heavy volume. Volume is something Charlie watches very closely. In his experience, stocks on the way down usually don't hit bottom until the volume has subsided. Heavy volume in the upward direction is often a harbinger of more big moves. In six months from late 1984 to early 1985, he'd already made five times his money. Some of his friends were urging him to be sensible and to take his wonderful profit. This is where many investors would have tripped up, but having missed some spectacular gains in the 1970s, Charlie kept his focus where it belonged--not on the stock price but on the company itself.

In spring of 1986 Blockbuster opened an outlet in West Roxbury, a mile from Charlie's house. Suddenly, everything he had been hearing about came to life, and he could see the crowds for himself. It is a tremendous advantage for investors to have stores owned by immature public companies open in their neighborhoods. They get an early whiff of success or failure before Wall Street picks up the trail. Perhaps if there had been a Blockbuster in my own little suburb of Boston, I would have noticed what Charlie noticed. "My sons and I would go over there on Saturday night and count cars," he said. "The parking lot was always packed. I thought to myself, 'This is going to be incredible.'"

By late summer 1986, three new superstores had opened in Texas, and the Becks had bought franchise rights to four new cities. Revenues continued to grow at a rapid pace. A secondary stock offering was planned for September to raise money for more expansion. The company was changing its name from Cook Data to Blockbuster Entertainment.

A week or so before the offering, Charlie was reading Alan Abelson's column in Barron's, when he came to a pan of Blockbuster. Abelson's argument: Who needs another video store?

Abelson's comment produced a spate of selling that caused the stock price to drop 15 percent. Charlie was a fan of Abelson's, but he was confident he knew more about Blockbuster. The sales figures from Blockbuster showed that people were flocking to the new superstores. But enough investors backed away from the offering that instead of the anticipated $20 million, Blockbuster could raise only $3.7 million.

Wayne Huizenga, the Waste Management tycoon, entered the picture in late 1987. A partner with Scott Beck's father, Huizenga jumped on the Blockbuster opportunity, eventually taking complete control. "Now I was really impressed," Charlie says. "I was aware of the terrific job Huizenga had done at Waste Management. I also liked the fact that he wanted to concentrate on company-owned stores, more profitable than a franchise operation."

Toward the middle of 1987, Charlie started worrying about the stock market in general and the fact that he had too much money riding on one issue. So he sold a portion of his shares in the high 30s, just before the big correction in October of that year. Short term, this proved to be a smart move, because Blockbuster stock promptly fell by half, to $16. But longer term, he would have been better off to hold on to every share to get all of Blockbuster's tenfold gain over the next four years.

In 1989, another Wall Street expert spooked the shareholders. Lee Seidler, an analyst for Bear Stearns, made a big fuss over the company's practice of carrying a large quantity of older and less-popular video tapes on the books as assets, when in his opinion they were worthless. This, he argued, made the company appear more profitable than it was.

Seidler's salvo was taken so seriously that the stock price got clobbered (falling 36 percent). The accounting flap was still an issue six months later when Huizenga visited Fidelity in December 1989. I was running Fidelity's Magellan fund at the time and was impressed with his explanation. He said that even if the company changed accounting methods, the result would be a one-time earnings drop of 10 to 15 cents. This was peanuts compared to the tremendous growth of the company.

Having done his own research, Charlie didn't need to meet Huizenga to reach the same conclusion. He and his sons had traveled to New York, Connecticut, and elsewhere to visit other Blockbuster stores. Everywhere the stores were jammed with customers.

Today, Charlie still owns a big chunk of Blockbuster. The recent merger with Viacom, which in turn has swallowed up Paramount, has complicated the story considerably. He's studying the situation.

For all the benefit he's gotten from this one company, following its progress has taken him only a few hours a month. These days, Charlie works at his investing full-time, though his method is basically simple. Every morning, he scans the Nasdaq section of the business pages, looking for stocks that have fallen to new lows. From the Moody's OTC Industrial Manual and other sources, he finds out which of these beaten- down companies are cash rich with no debt and have a potential for a turnaround.

He is excited by the hundreds of new small companies launched at high prices in the hot IPO market of the past three years. Already, some of these 1,400 or so companies have fallen out of favor. Whenever we get the next sharp correction, Charlie will be ready to pick up the valuable pieces. --------------- Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan fund, the best performing of all mutual funds over a 15-year period, and he is a vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

KEYWORDS: Stock Investing Strategies

94/06-The Second Half Effect

Not only is this the right point in the business cycle to look at quality growth stocks, it's also the right time of year.

By Peter Lynch

In the seasons of the stockpicker, late in the year is when a small stock often loses its value, only to revive in January. Thus, aficionados of small stocks do their bargain hunting in November and December, then await the January Effect, when the small stocks come out of their holes. There's a different season for the quality growth stocks, though fewer people know about it. Spring to early summer is the best time to shop for potential bargains in great companies such as Home Depot, Johnson & Johnson , PepsiCo, Abbott Labs, and Gillette.

These big-name issues and others like them tend to bloom in the second half of the year, when the smaller stocks are starting to wilt. This Second-Half Effect is caused by portfolio managers who bid up the prices for quality growth stocks in the third and fourth quarters. I'll explain why in a minute.

This is a timely subject, because right now we're in the bargain phase before the Second-Half Effect takes hold in the market. What makes it even more interesting is that quality growth stocks have done poorly of late. While other kinds of stocks scored big gains from 1991 to 1993, as a group the quality growth issues went nowhere.

A representative list of these recent underachievers in the market appears at the end of this file. PepsiCo has been flat; Gillette, dull; H&R; Block, a brick; Rubbermaid, a stiff; Home Depot, nothing to write home about. McDonald's, the star performer of the lot, has outgained the S&P; 500, but that's the notable exception. Out of this dreary dozen, seven stocks are selling for near or less than their 1991 prices.

If this was your entire portfolio in 1991, you missed two years of excellent advances, particularly the run-up in cyclicals. As a group, the cyclicals shown gained 37 percent while the growth group gained only 3 percent.

If Home Depot, Johnson & Johnson, etc., had lost their knack for making money, I wouldn't be touting them now. But there is nothing fundamentally wrong with them. Over the long haul, these have been terrific investments. Their earnings go up every year. They have a habit of raising their dividends continually. The only problem is that their stocks have been overpriced.

In early 1991, I noticed this situation and issued a warning: Avoid expensive growth stocks. But don't give me the swami award for this call. I saw it coming on the charts. The technical mumbo jumbo that usually goes along with chart reading is beyond me, but there's a simple exercise that I've found to be invaluable. You can do it yourself. In fact, once you've digested the next two paragraphs, you'll be as capable as I am of sounding the alarm the next time the growth group gets overextended.

If you were to examine a chart showing Johnson & Johnson's annual earnings per share going back more than 15 years, you would see a steady, straight line of earnings growth. This is the typical footprint of a quality growth company: steady increases in earnings with only the occasional bobble.

A line showing Johnson & Johnson's stock price over the same period would looks like it was drawn with a shaky hand. The stock hit a high of $58 in late 1991, and it's been mostly downhill since. On such a chart, the price line and the earnings line, taken together, serve as an important reminder of what we're buying when we buy a stock: a share of the earnings. A glance at these two lines gives us a visual history of the price-to-earnings ratio of the company--what investors have been paying for the earnings along the way.

When the price line strays far above the earnings line, as it did for Johnson & Johnson in 1991, it means the stock is very expensive, and people are paying an unusually high price for owning Johnson & Johnson. I found similar gaps up and down the quality-growth list.

That's what told me three years ago that it wasn't the time to be adding Home Depot and Wal-Mart to a portfolio.

Such charts are found in books published by the Securities Research Co., but there's no need for the casual investor to subscribe. Most brokerage houses carry chart books in their libraries, and brokers will readily lend out their copies. For my purposes, charts don't need to be reviewed very often. It's a good idea to consult them before you buy a stock, then every six months or so thereafter.

While quality growth stocks were lagging the market from 1991 to '93, the cyclicals had a great run. Cyclicals came into vogue as Wall Street's portfolio jockeys anticipated an upswing in the economy. Investors who were savvy to this change in market leadership doubled their money in Bethlehem Steel and Deere & Co., and did better than that in Owens-Corning and Caterpillar .

Now consider what you would see on a chart for Bethlehem Steel, a company on our cyclical list. You would notice that the earnings-per- share line wanders all over the place. As any Wall Street Boy Scout can tell you, this is the footprint of a cyclical. Cyclical companies produce or sell big-ticket items such as tractors or cars, which people will buy in good times and put off buying in bad times. That's why the earnings are so streaky.

Quality-growth companies, on the other hand, sell small-ticket items such as hamburgers or shaving cream or necessities such as pharmaceuticals. People won't stop buying Tylenol and Band-Aids no matter what shape the economy is in. That's why Johnson & Johnson's earnings line is so beautifully straight.

I'll buy almost any company at some price, and whereas two years ago the growth group was overpriced and the cyclicals were cheap, now it's the reverse. Let's go back to the chart of Johnson & Johnson. The stock price has fallen and the earnings have risen to the point that the troublesome gap is almost closed. Other quality growth stocks are beginning to close their gaps as well.

This doesn't mean you can shut your eyes and pick a growth stock. Sometimes, a stock is cheap for good reason - the company has troubles. With every company, there is something to worry about, but the question is, which worries are valid and which are not?

You may have noticed I omitted Quaker Oats, Gerber Products, Kellogg , and other food companies from our list of 12. These are solid growth companies, but at the moment their stocks are not cheap. The cereal and baby-food business has become highly competitive, with everybody fighting for market share by cutting prices. Price wars are not good for earnings, so this is a valid worry.

A less valid worry is the one that says U.S. health care reform with price controls on drugs would ruin Johnson & Johnson. My research tells me that Johnson & Johnson gets only one third of its revenues from pharmaceuticals. And more than half of those come from overseas, where price controls on drugs have existed for years. So whatever happens in the U.S. political arena won't affect J&J; as much as people think.

This brings us back to the Second-Half Effect. One of the natural tendencies of fund managers is to start the year dwelling in the present, but then to begin to anticipate the future as soon as the snow melts. In the winter months of 1994, they were thinking about 1994 earnings. For instance, McDonald's is expected to earn $3.36 this year. But when summer rolls around, analysts begin to think about 1995 earnings, when McDonald's is expected to earn $3.83. On the basis of 1995 earnings, McDonald's stock suddenly looks cheap. So a lot of people buy it, and the price goes up. Nothing has changed, except a page has turned on the calendar.

The Second-Half Effect does not apply to cyclicals. Their earnings are too unstable. Is Alcoa cheap on 1995 earnings? Who can say? What Alcoa will make in 1995 is anybody's guess. What it will make in 1994 is anybody's guess. It all depends on the price of aluminum, and you do need a swami to predict that.

I can't say enough about the fact that earnings are the key to success in investing in stocks. No matter what happens to the market, the earnings will determine the results. In 30 years, Johnson & Johnson's earnings are up 70-fold, and the stock is up 70-fold. Bethlehem Steel earns less today than it did 30 years ago, and guess what? The stock sells for less than it did 30 years ago.

In a bear market, the Johnson & Johnsons will suffer right along with the Bethlehems (although perhaps not as much), and nobody will be happy. But between Bethlehem with its spotty record and Johnson & Johnson doubling its earnings every six or seven years and raising its dividend like clockwork, which would you like to have in your portfolio a decade from now? --------------- Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 through 1990 he managed the Magellan fund, the best performing of all mutual funds over a 15-year period, and he is vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

TABLE: GROWTH STOCKS Abbott Labs (ABT) Genuine Parts (GPC) Gillette (G) H&R; Block (HRB) Home Depot (HD) Johnson & Johnson (JNJ) McDonald's (MCD) PepsiCo (PEP) Rubbermaid (RBD) Toys 'R' Us (TOY) Wal-Mart Stores (WMT) Warner-Lambert (WLA)

TABLE: CYCLICALS Alcoa (AA) AMR (AMR) Armstrong World Industries (ACK) Bethlehem Steel (BS) Caterpillar (CAT) Cincinnati Milacron(CMZ) CSX (CSX) Dana (DCN) Deere (DE) Dow Chemical (DOW) International Paper (IP) Owens-Corning (OCF)

KEYWORDS: Stock Investing Strategies, Stock Market Trends

94/08-The Stock Market Hit Parade

What do the great successes of the past 20 years tell us? It's the company, stupid.

By Peter Lynch

What can we learn from the hit parade of the stock market, the top 100 winners over the past decade -- and the decade before that? The first thing I notice is the lack of household names. Coca- Cola, Gillette, Disney, and Wal-Mart crop up, and also PepsiCo and Blockbuster Entertainment, but celebrity issues are in the minority. Wal-Mart and Blockbuster began their winning decades small and uncelebrated.

If there was ever a doubt that small stocks make big moves whereas big stocks make smaller moves, the hit parade ought to put it to rest. The star performers on Wall Street come straight from nowhere. Most of them never got into the Fortune 500. At the outset of each of the two decades, only a handful of the eventual winners could be found in the Standard & Poor's 500.

A few are unknown to me even today, and I'm the guy who once managed a portfolio with 1,500 different stocks. How did I miss some of these? Nautica Enterprises, almost a 9,000 percent gainer? Genovese Drug Stores? Whitehall Corp.? New Hampshire Ball Bearings? Who would have thunk it?

In the 1973-83 period, small companies were doing so well that it took a 25-fold gain to make the hit parade. Meanwhile, the Dow industrials performed dully, rising from 850 to 1248. No wonder so many mutual fund managers outperformed the market averages in those years: They were picking above-average small stocks that turned in spectacular gains.

In the more recent period, the situation is somewhat reversed. The Dow tripled, going from 1258 to 3751, while small companies slumped a bit -- it took only a tenfold gain to make the second hit parade. So it's hardly surprising that the vast majority of fund managers in the 1980s were outdone by the so-called index funds that ape the averages.

Going down the two lists of winners from the past two decade (see the lists following this article), you get a quick read on the modern U.S. economy and the direction in which we've been headed. Disney and Coke are the only two Dow stocks. There are no aluminums, ores, or chemicals in either of the top 100s and only one paper company (Wausau), a lone steel company (Worthington), a small oil company (Holly), and one tire maker (Cooper). You have to search to find the cyclicals.

So what does this say? For one thing, since we are no longer a gritty industrial nation, we aren't likely to get spectacular returns from gritty industrial investments. And it's the rare cyclical that performs well enough over long stretches to make a hit parade. You can't go to sleep holding cyclical stocks for a decade and expect to be richly rewarded. The rich rewards are in growth stocks and special situations.

As you can see by the evidence, great growth companies come in endless variety. This is a point that can't be repeated often enough. Banks, S&Ls;, supermarkets, biotech, carpets, bubble gum, ballpoint

pens, sugar, and health care are all represented in the top 100. There are a few casino gambling companies, a few stodgy financial companies, and a couple of insurance companies to boot.

Investors who put on blinders and ignore entire categories of companies, such as the stodgy utilities, or the lousy airlines, or the silly candy makers that only sell to a bunch of kids, are missing out on some great deals. Stodgy utilities? Not General Public Utilities, the owner of Three Mile Island, which almost made the hit parade with a 1,000 percent gain on its stock in the latest decade. The lousy airlines? A lot of people will tell you never to put a penny into that mess. Yet here we find three airlines -- Comair, Atlantic Southeast, and Southwest , with the latter two high on the winner's list. Southwest's stockholders made 12,000 percent from 1973 to 1983.

If it's a choice between investing in a good company in a great industry, or a great company in a lousy industry, I'll take the great company in the lousy industry any day. Good management, a strong balance sheet, and a sensible plan of action will overcome many obstacles, but when you've got weak management, a weak balance sheet, and a misguided plan of action, the greatest industry in the world won't bail you out. Here's my investment motto of the month: It's the company, stupid.

Notice the number of bank stocks on the recent winner's list? Eleven, by my count. The period from 1983 to 1993 was the best of times for some banks and the worst for others. There were S&L; fiascoes and bank failures galore, but a long drop in interest rates and an accommodating Federal Reserve helped many banks to record profits. And look who made the most of it. You don't see Citicorp or J.P. Morgan on the hit parade. You see River Forest Bancorp and Trustco Bancorp of New York , and a couple of obscure S&Ls;, Tompkins Country Trust Co. of Ithaca and National Commerce Bancorp of Tennessee. Imagine all the Ithacans who bought Dow stocks to be in the big time with proven winners and missed Tompkins Country Trust in their own backyard.

The retailers make a strong showing on both lists: the Gap, Blockbuster, Home Depot, Bombay Co., Circuit City , and Heilig-Meyers (a furniture seller) on the later, and Wal-Mart, Mac Frugal's Bargains Closeouts, the Limited, Charming Shoppes, Dunkin' Donuts, Hechinger, Pep Boys -- Manny Moe & Jack, Tandy (owner of Radio Shack), and Service Merchandise on the earlier.

I've always been partial to retailers (a poorly kept secret), and to find them on a hit parade is no surprise. Retailing is easy to keep track of, and there's great potential for earnings growth by expansion. All a company has to do is take a successful store and clone it. What sells in Pomona is an odds-on favorite to sell in Phoenix, and in Peoria, etc. Meanwhile, if somebody improves on the idea and opens a similar but better store in Philadelphia, so what? The new rival isn't going to hurt business in Pomona until the competitor puts a store in Pomona, and that may never happen in this lifetime.

With retailers, you can see the competitors coming, and you can see when a company has reached the saturation point with a store in every mall and on every other street corner. That's the time to think about selling the stock, but until that point is reached, a successful chain of stores can multiply its sales and its earnings at an exponential rate. It happens again and again.

It tells you something that only two companies made the top 100 in both decades. Fast-growing companies can't be expected to keep up the pace forever. Eventually, they reach middle age and lose some of their oomph, just like the rest of us. They encounter obstacles.

But it also tells you something that of the two repeat performers, Circuit City is a retailer and Hasbro is a manufacturer that sells to retailers. Successful retailers have a lot of staying power. They can grow for a lot longer than people think. If they run out of room in the U.S., they can go overseas, just like McDonald's has, and Coke, and PepsiCo, and Toys 'R' Us. McDonald's doesn't show up among the winners, but it's been an outstanding growth company and a terrific stock -- a 100-bagger in 25 years.

On both lists, there's no lack of high-tech stuff, companies with names like E-Systems and Pneumo Corp., Matrix and Teledyne, Scimed and Gentex , EDO and Biomet , Amgen and Alpha. In hindsight, it would have been nice to have owned these stocks, but my advice is: If you don't know what it means, don't put money into it. Why take chances with a Biomet when you can do just as well or better with a Wrigley's or a Tootsie Roll?

Did you notice that among all the high-tech issues, biogenetic companies, science labs, etc., there's not a single computer? Computer parts, yes; support services, yes; the software and the chips are all represented, but there's no IBM or Digital or Compaq or Apple. It's one more example of how the suppliers to a hot industry, the residual players, can fare better than the main competitors who are engaged in a desperate struggle to knock each other off.

In the end, what's most gratifying about these two lists is they prove that there's equal opportunity on Wall Street. Small companies can come out of humble circumstances and rise to the top, creating jobs, creating wealth, creating a better world for everyone. What long-distance company is on the hit parade? Not AT&T; but LDDS Communications. The winning airlines are the three regional carriers mentioned above.

It's Horatio Alger all over again -- small companies outdoing the big companies and taking up the slack when the big companies lay off workers. More than 2.1 million small companies were started in the U.S. in the 1980s alone. If each one, on average, employs ten workers, that's 21 million new jobs!

Europe has small companies, but not nearly the number we have, which may explain why the European recession has been more severe than ours was. Small companies may be our greatest national assets. There's no doubt they are our greatest investments.

--------------- Peter Lynch writes the Investor's Edge column for each issue of Worth. From 1977 to 1990 he managed the Magellan fund , the best performing of all mutual funds over a 15-year period, and he is a vice-chairman of Fidelity Management and Research. His latest book, Beating the Street, is published by Simon & Schuster.

TABLE: The Stock Market Hit Parade

The following table is a companion to "The Stock Market Hit Parade" by Peter Lynch. It lists the top 100 stocks from 1983 to 1993 and the top 100 from 1973 to 1983, ranked according to total returns over those periods, including reinvested dividends.

(NOTE: To view this table more clearly on your computer, you may wish to use a monospaced font, such as Courier. Using a monospaced font will cause the columns to line up correctly.) ---------------

TOP 100 STOCKS

From 1983 To 1993 From 1973 To 1983

1. Franklin Resources Key Pharmaceuticals 2. Nautica Enterprises Pulte Corp. 3. LDDS Communications Plenum Publishing 4. Blockbuster Entertainment Southwest Airlines 5. Unico American SCI Systems 6. Capitol Transamerica Kroy Inc. 7. Amgen Comdisco 8. International Game Tech Mac Frugal's Bargains 9. U.S. Healthcare The Limited 10. Molecular Biosystems Manor Care Inc. 11. Atlantic Southeast Air Charter Medical 12. The Gap National Education Corp. 13. Keane Inc. Resorts International 14. Mark IV Industries Metromedia Inc. 15. Bridgford Foods Corp. A.G. Edwards & Sons 16. Shaw Industries Loral Corp. 17. Superior Industries Mirage Resorts 18. Irwin Financial Corp. Gerber Scientific 19. Gentex Corp. United Artists Ent.-CIA 20. Tyson Foods Inc. Pneumo Corp. 21. Mexico Fund Galen Health Care Inc. 22. Crown Crafts Inc. Matrix Corp. 23. SCIMED Life Systems TSX Corp. 24. Holly Corp. E-Systems Inc. 25. Crompton & Knowles United Industrial Corp. 26. Stewart & Stevenson Svcs. Bruno's Inc. 27. Wm. Wrigley Jr. Co. SCOPE Industries 28. Associated Communications Coachmen Industries 29. River Forest Bancorp Circuit City Stores 30. Jones Spacelink Limited Forest Laboratories 31. Allcity Insurance Co. Optical Radiation Corp. 32. ABS Industries Inc. Zero Corp. 33. McClain Industries Inc. Financial Corp. of America 34. Tootsie Roll Industries Pandick Inc. 35. Danaher Corp. SCOA Industries 36. Wausau Paper Mills Co. Ames Department Stores 37. Ballard Medical Products Community Psychiatric Centers 38. Smithfield Foods Inc. National Convenience Stores 39. CUC International LIN Broadcasting Co. 40. Home Depot Care Corp. 41. Frozen Food Express Ind. Pall Corp. 42. Mylan Laboratories Wal-Mart Stores 43. Total System Services Tele-Communications Inc. 44. National Penn Bancshares Chris-Craft Industries 45. Cracker Barrel Old Country Pacific Scientific 46. Paychex Inc. Teledyne Inc. 47. Walt Disney Co. Worthington Industries 48. Paxar Corp. Espey Mfg & Electronics 49. Natl. Commerce Bancorp/TN MEI Corp 50. Trustco Bancorp/NY Tandy Corp. 51. Leucadia National Corp. Food Lion Inc. 52. Falcon Products Inc. Michigan Sugar 53. Tompkins Country Trust Dean Foods Co. 54. Century Telephone Ent. Fay's Inc. 55. Andrea Electronics Corp. Adams Russell 56. Circus Circus Enterprises Flight Safety International 57. Equitable of Iowa Cos. Analog Devices 58. Cooper Tire & Rubber Service Merchandise 59. Biomet Inc. Postal Instant Press 60. Comcast Corp. Charming Shoppes 61. Total-Tel U.S.A. Comm. Dreyfus Corp. 62. Bic Corp. O'Sullivan Corp. 63. Clayton Homes Inc. Advanced Micro Devices 64. Newell Co. Logicon Inc. 65. Arnold Industries Alpha Industries 66. Bombay Company Inc. Dynamics Corp. of America 67. Johnston Ind.-Del EDO Corp. 68. Modine Mfg. Co. Bairnco Corp. 69. Vornado Realty Trust Applied Data Research Inc. 70. Gillette Co. Anixter Bros Inc. 71. The Progressive Corp. G. Heileman Brewing Co. 72. Coca-Cola Co. Dunkin' Donuts 73. Financial Inds. Corp. Barry Wright Corp 74. Computer Associates Herman Miller Inc. 75. Comair Holdings Guilford Mills Inc. 76. Hasbro Inc. Russell Corp. 77. Harlyn Products Luby's Cafeterias Inc. 78. Circuit City Stores National Medical Enterprises 79. Telephone & Data Systems AEL Industries 80. PepsiCo Inc. Bob Evans Farms 81. Juno Lighting Genovese Drug Stores 82. Berkshire Hathaway Whitehall Corp. 83. Nature's Sunshine Products GCA Corp. 84. St. Jude Medical United Cable Television 85. Heilig-Meyers Co. Hasbro Inc. 86. Bemis Co. Thomas Nelson Inc. 87. Olsten Corp. Pep Boys- Manny Moe & Jack 88. Myers Industries New Hampshire Ball Bearings 89. Uniflex Inc. Sensormatic Electronics 90. Rowe Furniture W.A. Krueger Co. 91. Boston Bancorp Esquire Inc. 92. Washington Mutual Svgs Timeplex Inc. 93. Fannie Mae Veeco Instruments 94. Jacobs Engineering Group John Blair & Co. 95. First Financial Management Computervision Corp. 96. A. Schulman Inc. Lockheed Corp. 97. First Financial/Wisconsin Apogee Enterprises 98. Fifth Third Bancorp Butler Intl Inc. 99. Sealed Air Corp Hechinger Co. 100. First Empire State Corp. Subaru of America

Source: S&P; Compustat Services, Inc.

94/09-Wall Street v. Five-Line Family

America is phone obsessed, yet the markets hate phone companies. It's time to ask: Do the Bells still toll for individual investors?

By Peter Lynch

This year marks the tenth anniversary of the breakup of AT&T;, alias Ma Bell, in the settlement of the biggest antitrust case ever. The Justice Department required AT&T; to split itself into eight parts, with Ma going her way and the seven new Baby Bells going theirs. The Baby Bells got control of the local phone service in each region. Ma Bell kept the long distance.

Like the former Soviet Union, the old AT&T; was a vast enterprise, often accused of being sluggish and outdated. In its heyday, it employed 1 out of every 100 American workers. It controlled virtually all the phones and all the phone lines. To make a call without Ma Bell, you had to use tin cans and a string.

AT&T; was also the nation's most popular and widely held stock, with 3 million shareholders. Institutional investors avoided it, but small investors have always loved it. The breakup didn't dampen their ardor. For every ten shares of Ma Bell, they got one share in each of the Baby Bells. Ten years later, the four most widely held stocks in the U.S. are Bells, and the remaining Bells are in the top 15.

Meanwhile, AT&T; continues to rank near the bottom of institutional ownership -- which for a large growth company is quite unusual -- and the pros have ostracized the other Bells as well. This has been a bad choice on their part, because the Bells as a group have made investors five times their money since the breakup, while the S&P; 500 has merely tripled. Since a large majority of fund managers have underperformed the S&P; during this period, only one conclusion is possible: The unsophisticates who stuck to their Bells have once again outfoxed the experts.

Until 1990, the offspring flourished while Ma Bell lagged, but lately it's been the other way around. Ma Bell has held its own against some stiff competition, and investors have responded by bidding up the shares, whereas the rest of the Bells have barely advanced. Because they are regulated like electric utilities and pay big dividends like electric utilities, they've been lumped together with electric utilities in the recent massive sell-off.

The big question, of course, is where the Bells go from here. In the end, their prosperity, or lack of it, will depend on who controls the phone lines and who is allowed to offer service to whom. So do not ask for whom the Bells toll, ask from whom they'll be collecting tolls, and whether they'll be collecting enough to make for a good investment.

Let's start with the bullish argument. The bulls say it's unfair to throw out the phone companies with the power companies. Electric utilities are bedeviled by rising costs and almost no growth, whereas phones have become a way of life. A five-line family is no longer out of the question, with one line for the teenagers to breathe into and one dedicated to the fax, plus a home phone and a home-office phone and the cellular unit, which has supplanted the cigarette as the most likely object to be carried into a

party. There's shopping by phone, conferencing by phone, and pretty soon they'll have to put nonphone sections in restaurants.

On the cost side, roomfuls of operators have been replaced by machines and digital voices that don't require health insurance. Switching equipment is more compact and easier to manage than it once was. We've seen a 30 percent increase in phone hookups nationwide in the past 10 years, but phone-company payrolls have been cut in half. In 1984, a typical Baby Bell employed around 70 people per 10,000 phone lines. In 1994, they've got it down to about 35 people per 10,000 lines.

This is the heart of the bullish case for the Baby Bells. Demand is up and costs are down. These companies have staying power. At current prices, their stocks are yielding slightly more than 5 percent. It's the highest percentage the Bells have ever paid in dividends, relative to the S&P; 500, which currently pays 2.8 percent. On top of that, the Bells have picked up some valuable assets on the side, most notably the cellular franchises.

Cellular started out as a fad, a curiosity, a CB radio for yuppies. In each region, two franchises were awarded, one to the local Baby Bell and the other to a lottery winner -- Hillary Clinton was in a partnership that won a stake in a franchise in Arkansas. Who could have imagined that by 1994 we'd have over 16 million cellular subscribers nationwide, and no end in sight to the line of recruits? With 6 percent of the population already cellularized, that makes 94 percent who are still potential customers.

Recently, we found out what one of these cellular franchises is really worth. The California Baby Bell, Pacific Telesis, decided to spin off its cellular as a separate business and make it a gift to shareholders. For every share of PacTel, you got a free share of AirTouch Communications. These AirTouch shares now trade on the New York Stock Exchange for about $25 apiece. PacTel without the Airtouch is selling for about $30 a share, so the cellular part turns out to be almost as valuable as the rest of the phone company.

Thanks to the Los Angeles commuters who use their car phones for companionship while they're trapped for hours on freeways and the Hollywood types who make deals while they're jogging, PacTel was number one among the Bells in cellular, with the most customers and most revenue. But the other Bells have built up sizable cellular operations in their regions, and they've bought additional franchises from lottery winners outside their regions. Along the way, they've acquired paging services, cable TV assets, real estate, and bits and pieces of phone companies in Mexico, Russia, and elsewhere.

I got the rundown on Southwestern Bell from Bill Deatherage, a telecommunications analyst for S.G. Warburg. Southwestern has a cellular business that's worth an estimated $13.75 a share, a large stake in the Mexican telephone system ($5 a share), and other assorted properties ($3 a share). That's almost $22 in extras beyond the basic phone service. Deatherage figures the total package, minus the company's debt, is valued at $55, and the stock is selling for $43.

At the moment, Deatherage's favorite Bell is U S West . That stock sells for $42. Every share gives you $5 worth of cellular, $6 worth of Time Warner, $3 in international cable and cellular, $4 in real estate, and $4 in assorted odds and ends. When the company's debts are subtracted, you're left with $58.75 worth of assets.

But before we get too carried away with the bullish case, let me give you the bearish case. The crux of it is that the Baby Bells are losing control of local phone service. Where once they enjoyed a monopoly, now they have to fight off a growing number of competitors, especially for long-distance hookups, known in the trade as "handshakes."

Even though the Baby Bells are not long-distance carriers per se, they get paid for every toll call that begins or ends in their area. On an average call, one costing 17 to 18 cents per minute, the Bells at each end get 3 to 4 cents for transporting the call to and from the local lines to the long-distance lines. Where I live, near Boston, a long- distance call is any call that travels beyond the next town, so a piece of this action is very important to my regional Bell, NYNEX.

Imagine how much cheaper long distance would be if there weren't a Bell at each end. It's already happening in the business districts of major cities, where the so-called competitive access providers, or CAPs, have arrived with their fiber cables. A CAP can connect a local business to a long-distance carrier and cut the local Bell right out of the equation. The Bell is forced to cooperate with its enemies by letting the CAPs install switching equipment on its own premises. Recent court decisions may change this.

The CAPs won't be coming to my house or yours anytime soon, but they have connected enough cables to enough businesses to take a sizable bite out of the Bells' revenues. The Bells are putting up an active resistance. One -- Bell Atlantic -- recently won a court case that frees it from obligation to let the CAPs set up shop in its central office. All seven Bells are seeking permission to compete in the long-distance market, just as other companies have been allowed to compete in their local markets.

Sibling loyalty counts for nothing here. Southwestern Bell recently sought court approval to offer local phone service to a town in Maryland, in the middle of Bell Atlantic's territory. If this holds up, it will be every Bell for itself.

An advocate of the bearish viewpoint regarding the Baby Bells is Jack Grubman, telecommunications analyst for Salomon Brothers. While Grubman acknowledges the value of cellular, etc., he thinks the benefits of cost-cutting are overrated, because whenever a Bell can save a dollar by laying off a worker, it will lose a dollar to the lower rates that result from the fierce competition. He regards the big dividends as something of a hindrance, because they leave the Bells perpetually short of cash. Since it may ultimately cost them billions to rewire their systems to keep up with new technology, they're going to need all the cash they can get.

Grubman rates the Bells as holds. He sees them as 5 percent to 7 percent growers. He prefers long-distance carriers: AT&T;, MCI , and Sprint, in that order -- each of which he thinks can keep up double-digit growth rates. He says the long-distance carriers are growing as fast as many drug companies, but their stocks are much cheaper on earnings.

The future of the Bells and the CAPs, and everybody else in the phone business for that matter, depends to a large degree on the whims of the regulators, the politicians, the courts, and the deal makers on Wall Street. Will the telephone company bring movies into the house, or will the cable company offer telephone service? Will the CAPs be put out of business, or will they capture more revenues from the Bells? Will the Bells be allowed to compete with the long-distance carriers, especially on the calls that begin and end in their regions? Will their various alliances with cable companies and overseas telephone companies prove profitable? Will they be allowed to make massive raids on each other's territory?

There are more questions than answers, and a lot of work for the fortune tellers. But all things considered, I wouldn't bet against the Bells. In fact, I own two of them myself, Southwestern Bell and NYNEX. In the bull market of 1991-93, these stocks went nowhere, and in the decline of 1994 they're falling along with the rest. With their dividends paying almost twice the yield of the S&P; 500, they already reflect a gloomy prognosis.

Wall Street is betting that the Bells will be the losers in the legislation coming out of Congress, but they have a lot of moxie and a lot of clout in Washington. Clout doesn't show up anywhere on a balance sheet, but in a regulated industry, it's the most valuable asset of all. --------------- Peter Lynch writes the Investor's Edge column with John Rothchild for each issue of Worth. From 1977 to 1990 Lynch managed the Magellan Fund, the top-performing mutual fund in the industry. He is vice-chairman of Fidelity Management and Research and the author, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon & Schuster.

KEYWORDS: Telecommunications Industry, Stock Investing

94/10-What Goes Around Turns Around

How to catch companies that are on their way back and avoid companies that are on their way out.

By Peter Lynch

Investing in troubled companies that show signs of turning around can be a profitable pastime. But turnarounds are a tricky business in which timing is everything and patience is not necessarily rewarded. Flower children at the first Woodstock have gotten gray hair waiting for Avon Products to come back. Rip Van Winkle would still be waiting for Bethlehem Steel, whose stock hit its all-time high in 1956.

The first challenge in analyzing a company in distress is to figure out if it's going to survive long enough to work out its problems. This is where large, well-known companies have an advantage over smaller ones. Big companies got that way by being successful, and most of them own valuable assets: real estate, subsidiaries, cash in the till. Chances are they've got a good credit rating, and bankers will lend them money in a pinch.

Small companies are more likely to be living in rented office space with rented equipment. They have limited amounts of cash, which will soon run out if they need to use it to cover their losses. Their bankers may not be so eager to rescue them with new lines of credit, and their competitors would love to put them out of their misery. That's why troubled small companies declare bankruptcy in droves and disappear from the stock exchanges, whereas I can think of only a handful of big companies (Pan Am, Eastern Airlines, First Executive, Bank of New England, and a couple large Texas banks) that have gone kaput in recent years.

So when I'm looking at a possible turnaround, I do a solvency check right away. Generally, it's the big outfits that have the resources to muddle through, but you can't assume that. In the early 1980s, when Chrysler's survival was in doubt, its shares were selling for $2 apiece. People who were daring enough to buy Chrysler on its deathbed made 20 times their investment -- but they could have lost everything. I waited until Chrysler got an infusion of cash, thanks in part to a government bailout loan. By then its shares were selling for $4, so eventually I made only 10 times my money, but at less risk.

Chrysler turned around relatively quickly, but most big companies don't. This is where investors get fooled. They see a famous company with a glorious history that's fallen on hard times, and they notice the share price has dropped, and they snap up this supposed bargain in the belief that a turnaround is imminent. A decade, two decades, three decades later, it still may not have happened. International Harvester, now Navistar, ran out of steam in the 1960s. General Motors began to lose its pizzazz around the time the Beatles first landed in New York. Sears reached its pinnacle of $61 in 1973, when Richard Nixon was in the White House erasing the Watergate tapes.

The bottom fishers who bought Sears at $45 a year later, in 1974, and held on to their shares through all the ups and downs have nothing to show for their patience. In 1990, Sears was selling for the same price it fetched 16 years earlier. You would have missed the bull market in the 1980s by investing in Sears.

It's one thing for a company's earnings to decline in a recession or because of a temporary misfortune such as a labor strike or a hurricane or a bad marketing decision. But when there's a steady and prolonged drop in revenues, then you're looking at a serious, fundamental setback that won't be corrected overnight. The key lesson here is, you don't have to rush in to buy shares. You can afford to wait. In some cases, you can't afford not to wait.

Once a troubled company faces up to its predicament (this, too, can take time), it will announce a plan for recovery, which usually involves taking an ax to the budget. Here again, the would-be investor must be careful, because while cutting the budget may boost profits in the short run and create the impression that the company has put its troubles behind it, the real work has scarcely begun.

The hard part is winning back customers and reversing the decline in sales. A company that continues to spend less to make less will eventually have nothing to spend and nothing to make.

I should have reminded myself of this lesson before I invested in 50-Off Stores, a company that couldn't be more aptly named. 50-Off sells discount clothing in a chain of outlets strung across the southwestern U.S. The stock price hit a high of $32 in 1992, and then 50-Off went into a tailspin. Customers lost interest in its inventory of bargain- basement merchandise, and the stock itself fell to a bargain-basement level: $12. Or so I thought.

I visited three 50-Off stores in Texas and was impressed with a snazzy kid's shirt that I bought for a friend. More to the point, the company announced major changes and budget cuts and an exciting new array of bargain dry goods. Yet instead of waiting for results of these reforms to show up on the earnings line, I bought the stock posthaste, along with the shirt. The next thing I knew, the stock had two 50-off sales in a row, dropping to $6 and then to $3. It is currently at $4, slightly above book value.

Another lesson I've learned from experience is not to expect too much from companies on the mend. Occasionally, you'll stumble onto a Chrysler or a Fannie Mae, where you can make 10 to 20 times your money, as Magellan's shareholders did during my tenure at the fund. But comebacks are rarely that lucrative. A double or a triple is normally a great result. You get your ten-baggers from young companies in their fast-growth phases, not mature companies in a midlife crisis.

Turnarounds don't always happen once and for all. Sometimes there are false starts. Sometimes there are lapses and relapses. Chrysler, for instance, has had two turnarounds since the early 1980s. Kmart has had at least two since its heyday in the 1960s. Pier 1 , a perennial favorite of mine, is going through its third. I own the stock, and it's on my list of favorite turnarounds. The company has closed unprofitable stores and revamped the merchandise. Sales are up, and Pier 1 has a good chance of making record earnings this year. The stock is selling for half its price of five years ago.

Here are three more of my current favorites, each with concrete evidence of a turnaround and each of which I own:

GM: I've been touting GM since 1992, when it was selling for $32 a share. The way I see it, GM's diversification gives it an advantage over a one-dimensional enterprise like IBM. While GM's U.S. auto business has been a constant source of headaches and losses, its other operations (Hughes Aircraft, GMAC, Electronic Data Systems, U.S. trucks) have been highly profitable all along. For GM to rise again, all it has to do is break even on cars in this country.

GM has taken all sorts of steps to reduce costs, but what got my attention was how it turned around its European auto business a few years ago, then brought the key players from the team that accomplished this feat back to the U.S. to do the same at home. In the second quarter of 1994, GM wowed Wall Street by reporting the best quarterly earnings in its history: $1.9 billion. I suspect the best is yet to come.

SEARS: Sears closed its famous catalog, which was losing money, and added 200 small stores in rural areas to serve its former catalog customers. It sold 20 percent of its insurance subsidiary, Allstate, to the public in the biggest initial public offering in history and used the proceeds to improve its balance sheet. It has remodeled its stores and brought in new merchandise. It is doing well in Mexico. The outlook for Allstate, which contributes half of Sears's earnings, is favorable.

If everything continues to click, Sears has a chance to break its record and earn $5 per share in 1995. Meanwhile, the stock sells for $46, $15 below the record price.

TANDY: Tandy has overhauled its basic business by selling off its computer-manufacturing operations. It is now a pure retailer, with 6,500 Radio Shack stores and $250 million in excess cash. Radio Shack has become a kind of 7-Eleven for household electronics, and soon all these outlets will offer repair service for items that are normally a hassle to get fixed. Bring your portable phone, VCR, answering machine, etc., to the neighborhood Radio Shack, and Tandy will ship it to one of its centralized repair shops and return it in working order.

Moreover, the company has trotted out a couple of megastore retail ventures: Computer City for computers and Incredible Universe for electronics and appliances. Both are growing fast. It looks like Computer City will rack up $1 billion in sales this year, and Incredible Universe nearly half that.

Because the Radio Shacks are doing well already, Tandy's earnings are on the rise without either of the new ventures contributing much. If both prove profitable, it's easy to imagine Tandy becoming a growth company again, a remarkable achievement for a turnaround. Even if only one new venture succeeds, it will be a big boost to earnings and presumably the stock price. The company has also announced a plan to buy back 10 percent of its shares -- usually a very good sign.

There's no harm in taking a "show me" attitude toward turnarounds. Once in a while you'll miss a few dollars of profit by not getting in at the bottom of the successful cases. But in the unsuccessful cases, you'll save yourself a lot of money and frustration. Missing the bottom on the way up won't cost you anything. It's missing the top on the way down that's always expensive. --------------- Peter Lynch writes the Investor's Edge column with John Rothchild for each issue of Worth. From 1977 to 1990, Lynch managed the Magellan Fund, the top-performing mutual fund in the industry. He is vice-chairman of Fidelity Management and Research and the author, with Rothchild, of two books on investing. "Beating the Street," the latest, is published by Simon & Schuster.

KEYWORDS: Stock Investing

94/11-Finding Bargains Losers List

It's fall, when one investor's tax loss is another's bargain buy. Some of the best values may be in last year's IPOs.

By Peter Lynch

From January 1991 through September of this year, 1,765 new domestic companies were hatched on Wall Street -- a record for such a short period. The newcomers outnumber the entire population of the New York Stock Exchange.

Many of them shot out of the starting gate and attracted attention. But it's a lot harder to generate good news after that first blush. Of the recent arrivals, 831 were selling at press time for less than the prices at which they came public.

This tells us something very important about initial public offerings: There's no rush to buy shares at the outset, because there's an excellent chance they can be picked up more cheaply a few months down the road once they've started trading. People complain that only fat cats and institutions can get their hands on IPOs at the premarket prices, but in many cases brokerage houses are doing small investors a favor by shutting them out.

Why talk about the recent batch of new issues now? Because we've entered the fall selling season. That's when trees drop their leaves, and investors drop the losers from their portfolios. It happens every year, in plenty of time for people to claim the losses on their tax returns. For some reason, taking a loss is a pleasurable exercise -- many stock pickers look forward to it even though the tax break itself is no more than a partial compensation. There's a psychological benefit to tossing the bums out: The names disappear from the monthly brokerage statements; we're no longer reminded of our mistakes.

The stocks most likely to be dropped in the selling season are small- company stocks, a category that includes most of our recent IPOs. Small- company stocks are often purchased as flyers or speculations, and they lack the status of core holdings. As a rule, they aren't followed by Wall Street analysts beyond the initial coverage that accompanies the underwriting. So information about these companies and their prospects is hard to come by.

Even when they do know the details, the stock jockeys on Wall Street -- fund managers and so forth -- have a low tolerance for even a single stumble, or a "negative surprise," as it is called, from any new enterprise. "Everybody wants these nice pretty quarters after a company comes public," says Mary Lisanti, a small-cap fund manager at Bankers Trust who frequently searches for what she calls broken IPOs. "One bad earnings report and the stock gets tossed out."

So as we move into fall, people dispose of their flyers and speculations and disappointments. The dropping prices create more losses, which other investors are tempted to take. The selling leads to more selling. Below $5, a stock no longer can be counted as collateral in a margin account, so the margin buyers join in with the tax-loss crowd, the portfolio managers, and the camp followers who sell because

everybody else is doing it. Perfectly good businesses with excellent prospects are marked down to a fraction of their actual worth.

This creates a perennial opportunity for bargain hunters who rummage through the list of IPO losers. Granted, many of the 831 stocks on this year's list have dropped in price for valid reasons -- the companies they belong to have stumbled and bumbled repeatedly and may be lurching toward bankruptcy. So the first task of the bargain hunter is to narrow the field and separate the solid prospects from the ones that are counting on hopes, prayers, and miracles.

You could start by looking for the companies that have no debt. If a company is debt-free, then at least you don't have to worry that it will default on a loan.

Next, from among the debt-free companies, find companies that are selling for less than cash. Say a company has a million shares outstanding and $3 million in cash in the bank. That's $3 in cash per share. If the stock is selling for $2 per share, then you're in the enviable position of paying $2 to get back $3, with the company itself thrown in for free. Of course, whether this cash does you any good in the end depends on whether the company uses it wisely or fritters it away.

A company that is losing money will go through cash quite rapidly, so the next thing you want to worry about is whether it can make a living. Add a third element to your search: From among companies that have no debt and are selling for less than cash, look for companies that actually have earnings. You can take this a step further and seek out companies whose stocks are priced at less than ten times those earnings.

Some names on the losers list come from biotech or high tech, and their appeal is based entirely on an invention that has yet to be tested or a wonder drug that hasn't emerged from the petri dishes. You have to be an insider, an expert, a gambler, or all three to want to put money into these shares. But along with the risky what-ifs are the companies that have proved themselves with several years of consistent earnings growth.

If you operate a computer and can call up the right kind of database, you can run a screen to pick out the best-performing companies from among the IPO losers. Otherwise, you can do the research on a case-by- case basis. For starters, I've contacted three experts in the field who offer their own favorite downtrodden IPOs, and I've also put together a group of my own candidates for further study (see the list following this story).

Mary Lisanti recommends the following eight companies, all of which have shown they can turn a profit: Wandel & Goltermann Technologies (information networks), Digital Link (digital access products), Summa Four (telephone-switching systems), Filene's Basement (discount apparel), Jos. A. Bank Clothiers (men's apparel), Wind River (semiconductors), Damark International (discount mail order), and Protocol Systems (monitoring for hospital patients).

Robert Natale, editor of Standard & Poor's Special and Emerging Situations newsletter, says that picking from the losers' bin is not his favorite tactic, because the majority of the losers will go from worse to terrible. But he agrees there are some good buys to be found, and he's identified three of them: Capital Guarantee Corp. (insures municipal bonds), IGEN (medical products), and Payless Cashways (a chain of home-repair outlets similar to Home Depot).

Manish Shah runs a small investment company called Otiva and also publishes a newsletter, IPO Maven. A man after my own heart, he believes in doing research first and investing later, and he doesn't rush in to buy shares from the underwriters. "People shouldn't get caught up in the first hour of trading," he says. I couldn't agree more. It's the first two years, three years, five years, that really count.

Shah has been following IPOs for six years. He looks for companies in the 20-20-20 club: 20 percent sales growth for three years or more, 20 percent earnings growth, and a 20 percent ratio of debt to capitalization. To pass his muster, a company must also have a niche -- some sort of specialized product or service -- and the capacity to expand globally.

Again, Shah doesn't necessarily concentrate on IPOs selling below their offering price, but going down the losers list he chose the following: < wam-co NASD:RAWL>Rawlings Sporting Goods (sports jerseys and paraphernalia), O'Sullivan Industries (furniture maker, a Tandy spin-off), Software Etc. (software retailer), < wam-co NYSE:DGP>USX-Delhi Group (natural gas distributor), < wam-co NYSE:BOR>Borg-Warner (security systems), Allstate (insurance), Steck-Vaughn Publishing (children's textbooks, educational software), Paul Revere (insurance), Gateway 2000 (personal computers), Concord Holdings (back-office support for mutual funds run by banks, a Bank of America spin-off), Wandel & Goltermann (also on Lisanti's list), and Radica Games (hand-held casino games).

I can't leave this without repeating the usual Lynch disclaimer: These are not hot tips to take to the broker's office or the bank or the nearest trading desk. They are starting points for calling the company, getting the annual reports, quarterlies, and IPO prospectuses, and doing the research.

It's easy to overlook the fact that Home Depot, Microsoft, Apple Computer, Federal Express, United Healthcare , and other well-known companies that are the modern leaders of their industries, employing thousands of people and giving a great boost to the prosperity of the nation (not to mention the shareholders), began their public life on the IPO list. In some cases it wasn't that long ago. Somewhere from among the 1,765 recent new issues, the future corporate giants will arise.

LIST: STOCKS SELLING BELOW THEIR IPO PRICES

Arkansas Best Corp. (ABFS) The Finish Line Inc. (FINL) Dual Drilling Co. (DUAL) Boston Scientific Corp. (BSX) Petroleum Heat and Power (HEAT) Investment Technology Group (ITGI) The Allstate Corp. (ALL) Argosy Gaming (ARGY) Centex Construction Products (CXP) Borg-Warner Security (BOR) Filene's Basement (BSMT) Walker Interactive Systems (WALK) Kenetech Corp. (KWND) Alexander Haagen Properties (ACH) JDN Realty (JDN) ---------------Peter Lynch writes the Investor's Edge column with John Rothchild. Lynch is vice-chairman of Fidelity Management and Research and the author, with Rothchild, of two books on investing. "Beating the Street," the latest, is published by Simon & Schuster.

KEYWORDS: Stock Investing Strategies

95/01

Put Your Broker to Work

By Peter Lynch

What rarely happens at the gas station happens all the time at the broker's office. Millions of customers pay the full-service rate without getting the full services. In a nation of smart shoppers, this may be the last great lapse. With all the attention going to discount brokers and Wall Street firms vying to offer the lowest commissions, nobody is talking about how people whopay for full-service brokerage can get their money's worth. Thanks to the computer, full-service brokers are a far more valuable resource than they were a few years ago. They spend most of their working hours staring at the same information the fund managers on Wall Street are staring at. With the newfangled terminals that have replaced the clunky Quotrons of old, even a broker in the boonies is only a keystroke away from a menu of high-powered sources including Reuters; Dow Jones New/Retrieval; Bloomberg, which reports on the vital signs (cash flow, revenues, etc.)of thousands of companies; Zacks, which gathers earnings estimates from all the analysts who follow a particular company; and charts and graphs that track stock prices and volume of trading goingback weeks or even years.

Along with these data services, the broker can call up the latest

commentary from the in-house analysts at his own brokerage firm.This is the sort of fresh information retail investors normally can’t get. To find out what the Dean Witter analyst is saying about IBM, the clients of Dean Witter have had to wait for the written report, which often takes weeks to be printed and sentout to the local branches. By that time, the information is stale and the fund managers and other large investors have already acted on it, because they hear it straight from the analyst’s mouth.

I've argued over and over that the retail investor has an edge over the wholesale investor in many aspects of investing, but getting the latest news from official Wall Street sources isn'tone of them. Look what happens, though, if the retail investor’s broker is willing to pass along the analyst's comments as they appear on his computer screen. The information gap closes, and the retail investor no longer has to be the last to know.

"The research departments of the major brokerage firms are underutilized, “says Tom Reilly, a Merrill Lynch broker from Boston who enthusiastically plays the new role of conduit between his clients and his database.Merrill Lynch has about 200 analysts in 37 countries, and when everone of them writes a report on a company whose stock is owned by a client of his, Reilly can retrieve it. "When I came into this business 18 years ago," he says, "the printed reports we mailed out could be three months old by the time they reached the customer. Now I can print a copy off the screen and fax it. Or if there's something that the compliance department won ‘tallow me to print, I can at least read it to the customer off the screen."

Suddenly, there are better things to ask a broker than "Where’s IBM trading today?" - which tells you nothing about IBM's prospects- or "Is the market headed up or down?" - the question brokers have to answer every day, even thought they have no more idea of where the market's going than you or I do.

You can ask forthe latest news on IBM from the Dow Jones wire, or for the latestsummary of earnings estimates from all the brokerage analystson First Call, or for a copy of the most recent bulletin putout by the in-house IBM analyst.

Or, if you want the complete story all at once, the broker canpull the relevant details out of Bloomberg, Zacks, and the rest,and string the pages together to produce what amounts to a homemadereport on any company that piques your interest. Al Bernazani,a broker at Smith Barney with 35 years of experience, preparesthese information packages as a matter of routing. "I can generate20 pages of data on almost anything," he says, "and the computersprint it up at night."

It sounds like a lot of extra bother, but Bernazani, Reilly,and other brokers who are the pioneers of computerized servicessay it's not. They can gather 20 pages on the computer withoutleaving their swivel chairs, and in less time than it would taketo walk to the office library and copy a couple of pages outof the S&P; reports or the "VALUE LINE INVESTMENT SURVEY," whichis the traditional way of doing research for clients. That oldmethod doesn't compare with what's possible today.

Perhaps you're looking for companies with particular characteristics-- a low price-to-earnings ratio, or no long-term debt, or ahigh growth rate, or an unbroken record of raising the dividend,or all of the above. Ten years ago, there would have been noeasy way to search through 10,000 publicly traded companies tofind the suspects that fit the description, but now we've gotonline databases with screens. Some of these databases are soexpensive it wouldn't make sense for the average person to acquirethem, but the brokerage houses might. In that case, your brokercan run the screens for you.

It's not a commonplace request at the moment, but Tom Reillyalready runs screens for his clients, and there's no reason stockscreen can't become one of the standard full services. Meanwhile,useful information on annuities, foreign stocks, and mutual fundsof all stripes is piling up on broker's desks. Many offices alreadysubscribe to the Morningstar and Lipper publications that trackthousands of mutual funds: stock funds, bond funds, open-end,closed-end, foreign, domestic, best total return over ten years,highest yield, you name it. A broker can help clients pick mutualfunds by sending along the ratings and the rankings, yet fewinvestors take advantage of this. People who believe that allfunds seem the same might feel differently if they looked atthese reports from time to time.

It won't be long before a broker's entire client base can beput on an alert system, where any newsworthy development thataffects a specific stock or mutual fund will trigger a note tothe broker, who can then relay the information to clients whoown the shares. There are a least two programs that do this already:Reuters Money Network and Telescan. Both roam the news wiresautomatically, looking for news on the stocks in a subscriber'sportfolio whenever that subscriber logs on to get the latestprice quotes for the shares.

Computers have revolutionized the business to the point thatthe two most important factors to consider in choosing a brokerare: (1) Does he have good software and good databases? and (2)Is he willing to use them on his clients' behalf? This is wherethe larger offices, particularly the flagship offices in majorcities, have an advantage over the smaller, far-flung branches.Larger offices tend to have greater access to research and moreelaborate databases than smaller offices do.

Bernazani is in a great spot. He works at one of Smith Barney'smain offices in Boston, which has its own trading desk wherebig blocks of stock are bought and sold for institutional clients.An office with a trading desk is likely to have the most advancedresearch available, which is how Bernazani gets to use Bridge.Bridge is a premier database that runs 24 hours a day there andwill tell you everything you ever wanted to know about a company'saffairs short of the CEO's bedtime. It also tracks options andcommodities and does the mumbo-jumbo calculations used by theesoteric market timers know as quantitative analysts, or quants.It's a great service, but for an individual to subscribe, thecost can run to a hefty $2,000 a month. Bernanzani makes useof Bridge for his customers free of charge.

I'm amazed that full-service brokerage firms aren't advertisingthe research benefits their clients can get from their computersystems, but so far they've been quiet on the subject. Assetallocation is what they talk about. That's where they hand youa questionnaire that asks you how much risk you are willing totake, and a worksheet so you can figure out how much money you'llneed for retirement, or to pay tuition bills, or whatever. Basedon your answers they design a portfolio with the right mix ofstocks and bonds for your particular situation. Then periodicallyThey review the portfolio to see if it's underweighted or overweightedin one investment or another. It's a valuable service, but notas valuable to the stock picker as the help the broker can providead hoc.

There's potential here for a total overhaul of the relationshipbetween brokers and clients, which often has been less than satisfyingto either party. Instead of the brokers calling their customerswhen they have something to sell, now they can call when theyhave something to say. The client will benefit from having anactive research partner who does for him what the analyst doesfor the big players on Wall Street. The broker will benefit fromfelling more useful. The brokerage house will be able to showthat higher commissions are worth the price.

We're in the experimental stages here, so the client has totake the first step. Call your broker and ask him what he andhis computer can do on behalf of the companies you own stockin. It might be the beginning of a beautiful new relationship.

95/02-The Next Oil Boom

J.R. may be gone, but there are still opportunities to make a killing in oil--in the service companies

By Peter Lynch

It's hard to believe that more than a decade has passed since the heyday of Texas crude, when the Hunt brothers were riding high on the Forbes 400 list of richest Americans, Dallas was the world's most popular nighttime soap, the Arab sheikhs had bought up London, and everybody was scrambling to get into the "awl bidness."

All it took for the bidness to lose its glamour, besides Dallas going off the air, was a pesky decline in oil prices. This brought no joy to Rigville. The lower oil prices caused the Exxons and the Mobils to quit exploring for new sources, which left the drillers and the roust abouts with nothing much to do and a trail of bankruptcies and rusty rigs extended across several continents. The survivors have struggled along ever since, merging, cutting costs, and waiting for a new opportunity, which may soon open up.

We can't go much longer burning more and finding less. Lately, we've been living off oil fields discovered long ago--Prudhoe Bay and the North Sea--but these old supplies won't last forever. In fact, we're much closer to a shortage than the glut that people are worried about. You've read the stories: OPEC can't stick to its quotas, and once Iraq starts pumping, it will flood the market with 3 million extra barrels a day. What these stories don't mention is that with world consumption increasing by an annual 1.5 percent, each year we need another million barrels per day. At that rate, the Iraqi "flood" will be completely absorbed in three years' time.

It's the same story with natural gas: too many straws stuck in the drink. In the U.S., we're burning 20 trillion cubic feet a year, which is double the amount of new gas that's being discovered. The supply in the proven reservoirs has fallen from 290 trillion cubic feet in 1970 to 160 trillion cubic feet today. At the current burn rate, that's eight years' worth, which puts us as close to running on empty as we've been at any time in the second half of this century.

We continue to import from Canadian fields, but you can see where this is heading: More demand and less supply equal higher prices. So if you buy this scenario and you want to profit from it, you have two basic choices. You can invest in the oil producers: Exxon, Mobil, British Petroleum, et al. (Some of these stocks have had a decent run-up already, but there are still opportunities in the group, which I'll discuss in a separate column later in the year.) Or you can invest in the downtrodden oil-service companies that will benefit from the next pickup in drilling and exploration.

At that point, another kind of supply and demand will begin to work in favor of the oil-services outfits: the supply and demand for drills, bits, and rigs. The rig count, which is how oil hands keep track of this industry, has had quite a fall since1981, when there were 4,200 rigs operating in the U.S. and Canada and 1,400 in the rest of the world. Today, there are fewer than1,000 rigs at work in the U.S. and Canada and only 770 everyplace else. Very few industries have suffered a decline as severe as this one. In the

Gulf of Mexico and other watery locations, the offshore rigs have been vanishing at a rapid rate. They've almost become an endangered species.

The oil producers don't own rigs; they generally rent or lease them from the oil-service companies. So when they decide to start exploring again, they are going to be faced with a very tight market for rigs. This will be a fortunate situation for the owners of the rigs, who can raise the rents and name their price. They've already paid for the equipment, and it doesn't cost much to get it into shape, so the increased rent will pass through to the bottom line. That's why a slight pickup in drilling can be explosive for earnings.

But you can't just invest in oil services. You have to pick and choose among the land drillers, ocean drillers, pipeline operators, seismic mappers, downholers, rent-a-rigs, drill-bit manufacturers, tube makers, platform builders, and secondary-recovery companies. Oil services used to be a business in which muscles counted for more than brains, but lately it's gone high-tech. They've got 3-D seismic mapping. They've got new "smart" drills that go horizontal and can snake around the pathways and contours of the rock. They've got drill ships that can sink a probe in mid-ocean. They've got submersible rigs and semisubmersible pontoon vessels that float around like giant oil-sucking lily pads.

With their computer divisions, their science labs, and their Ph.D.s on the payroll, the most advanced of the oil-service companies have given up the he-man role to become technical advisors and consultants to the oil producers. In a sense, this sophistication hurts the old-fashioned drillers, because as the prospectors get smarter, they don't have to drill as many holes. The companies that have the brightest futures are those with the high-tech capability.

There's also been a lot of merger activity in the industry; thus, a handful of companies will dominate what used to be a fiercely competitive situation. The hulk in the lineup is Schlumberger, with annual revenues of $6 billion plus. Of the three analysts I contacted in researching this piece, two have put Schlumberger (NYSE: SLB) on their buy list.

Schlumberger executive vice president Victor Grijalva once admitted that the company had a King Kong complex, but that's been cured. The company let go of Fairchild Semiconductor, a conquest that was outside Schlumberger's regular line of work, and acquired a company in its own field, GeoQuest, a leader in seismic services that once belonged to Raytheon. Recently, Schlumberger has put its cash to better use, bought back stock, and managed to make money (more than $500 million after taxes in 1993) as the market for oil services has shrunk. It's not hard to imagine what will happen when the market begins to expand. The stock has been stuck in the $50–$70 range for several years, and lately it's fallen to the low end--$51 as of this writing. Analysts say it's going to go much higher, but even if it returns only to the top end, that's a 40 percent move.

Among various consolidations in progress, the one that looks the most promising to me is the upcoming merger between McDermott International's marine-construction division and a company called Offshore Pipelines. The result will be an entirely new company, J. Ray McDermott, which overnight will become the largest marine-construction outfit in the world. The parties to the merger were still awaiting final approval from the regulators when I wrote this, but the deal may have gone through by now.

If and when the merger is approved, James Stone at Werthheim Schroder predicts that the new company can cut $50 million in costs right off the bat, on the theory that two can live more cheaply than one. He estimates that cash flow will rise to $5 per share, and if he's right, we're about to witness an exciting development. Cash flow, simply put, is the money a company takes in. The normal ratio between the price of a stock and the cash flow of the company is about ten to one, but with Offshore stock selling at $20, the stock price to cash flow would be four to one.

You can approach this opportunity in one of three ways: buying shares now in McDermott (NYSE: MDR) or Offshore Pipelines (NYSE:OFP), or buying the new company, J. Ray McDermott. Stone thinks Offshore at around $20 is the better choice, assuming the merger hasn't happened yet. For each share of Offshore you own, you'll get a share in J. Ray, plus a 50 cent– per-share cash dividend thrown in as a bonus. James Carroll of Paine Webber favors buying the parent company, McDermott, which will continue to own 60 percent of the shares in J. Ray. He estimates that the J. Ray asset will be worth $12.50 a share to shareholders of McDermott.

Of the smaller, high-tech companies, Gordon Hall of CS First Boston recommends Western Atlas. It was spun off by Litton Industries in March 1994 at $40 per share, which is about where it sits now. Western Atlas (NYSE: WAI) is a leader in 3-D seismic services, which will be in great demand once the search for oil and gas begins in earnest. It's not cheap on earnings ($1.85 per share is estimated for 1995), but a cash flow of $5.45 makes it more attractive.

Finally, there's one I own: Tuboscope Vetco International. As you might have suspected, Tuboscope (Nasdaq: TUBO) is engaged in tubing and pipeline inspection. It's a specialized area, and not many companies are involved in it. At $6.50 a share, the company is cheap and attractive. It may earn 50 cents in 1995, which gives the stock a modest price-to-earnings ratio of 13. The estimated cash flow for 1995 is $1.35.

Last year, Tuboscope was almost bought out by Weatherford at $11 a share, and the company has announced it's still for sale. Somebody else could make a similar offer, but Tuboscope has a good chance of getting to $11 on its own.

But do your own research. Maybe you'll find some drillers you like. There are numerous companies in oil services that have gotten stronger and have sobered up considerably from the free-spending days. The ones that are making money now stand to make huge amounts when the price of gas and oil goes up. And if we get a burst of drilling activity and a rebound in seismic work and secondary recovery, we could see a heyday in oil services and a liftoff in these stocks to rival the liftoff in autos and chemicals that began in 1991.

Peter Lynch writes the Investor's Edge column with John Rothchild. Lynch is vice-chairman of Fidelity Management and Research and the coauthor, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon & Schuster.

KEYWORDS: Investment Strategies

95/03-Catch a Ride

Who says investing isn't fun? With this company you get both a great stock and a reason to try out Raptor.

By Peter Lynch

It's worth reminding ourselves from time to time that gyrations in a stock price may tell us absolutely nothing about the prospects of the company involved. A good example of this is Cedar Fair,L.P., a company that owns three amusement parks within driving distance of 65 million potential investors: Cedar Point, in Sandusky, Ohio, on the shores of Lake Erie; Valleyfair, on the outskirts of Minneapolis; and Dorney Park & Wildwater Kingdom, near Allentown, Pennsylvania.

Cedar Point dates back to 1870, and seven U.S. presidents have visited there, but its biggest claim to fame is that Knute Rockne invented the forward pass on the premises. It's listed on the National Register of Historic Places, and it has one of the oldest working wooden roller coasters in the world. So this is a company with a lot of experience. It also belongs right at the top of Lynch's hit parade of companies that are easy to follow.

You don't need a Ph.D. and a microscope to figure this story out, and there aren't 14 different divisions going off in14 different directions. The whole operation hinges on the three parks and how many customers they manage to attract in the four months a year during which they're open. That's the key ingredient in successful investing: finding companies you can keep track of so you've got a point of reference other than the stock price.

Cedar Fair tells you everything you need to know in the annual report, plus the very important third-quarter report sent to shareholders in November, after the summer season has ended. The most recent third- quarter mailing was a humdinger. It reported record crowds at the three parks in 1994, up 9 percent from 1993. (Disney and other park operators suffered a decline in attendance last year.) Revenues were up, earnings were up, and spending per visitor was up. The balance sheet was strong, and the company announced a record $24 million in capital improvements for1995.

The good news is out, and for a few months the parks will be closed and the roller coasters turned off, so nothing is going to happen to affect the company's prospects for a prosperous1995 and beyond. Yet the stock will continue to have its ups and downs, and investors who realize there's no reason for the downs can take advantage and buy more shares.

Since Cedar Fair went public in 1987, there have been at least four chances. The first occurred six months after the stock began trading at $10 a share. The market hit Black Monday, and a $10 share became a $6 share overnight. The company was paying a $1.05 annual cash distribution at the time, so the $6 buyers were getting an astounding 18 percent yield on their investment. You had to ask yourself: Is anything wrong with Cedar Fair that this stock should be this cheap?

The short answer was no, because the parks were already closed for the winter. The big fear at the time was that the U.S. would fall into a deep recession that would doom corporate America. So you then had to ask yourself: How does Cedar Fair do during a recession? The answer is quite reassuring. For the past 20 years, revenues have increased without a single lapse, during good times and bad. That's because, again, 65 million people live less than a tankful of gas from a Cedar Fair park: 22 million within reach of Cedar Point, 8 million within reach of Valleyfair, and 35 million within reach of Dorney. When money is tight, they can take a Cedar Fair vacation and spend far less than they would if they had to fly the family to Disney World. Disney is vulnerable to recessions because so many potential customers have to travel long distances to get there.

You got a second chance to buy Cedar Fair in the fall of 1990, when the U.S. military was preparing for the Gulf War. Thirteen dollars a share became $10.40 a share. Once again, it was off-season at the parks, so nothing had gone wrong at the company to justify this drop. You had to ask yourself: Was Saddam Hussein planning to launch a Scud missile attack on Cedar Point?

The third chance came in 1992, after Cedar Fair bought Dorney Park. Everything about this deal looked favorable, but several months after it was done, the stock price still hadn't budged. It was stuck in the $20 range, giving you plenty of time to study the situation and realize that Dorney was a great acquisition that more than doubled Cedar Fair's customer base.

It's not like Cedar Fair had brought home a wind farm or a biotech lab or something else it didn't understand. Amusement parks it knows how to run. The 20 top people in management have been with the company an average of 20 years apiece. They can take over a park that's down at the heels, renovate, spiff things up, advertise, and cut the overhead by folding the management into the Cedar Fair management. They buy the same trash cans, ticket booths, and roller coasters for all their properties, so they save money by getting a bulk rate.

This brings us to chance four, because while the company is posting record results, with earnings, revenues, and cash distributions on a continuous rise, the stock has fallen a long way from its high of $36.60 in1993. It hit a recent low of $26.75 in the fourth quarter of 1994, and as of this writing, it's selling for less than $29, giving it a very stingy price-to-earnings ratio of 10.

Again, the parks are closed, and again you have to ask yourself:What's the Street worried about this time? My guess is that there is concern about Cedar Fair losing its status as a master limited partnership. An MLP has a big tax advantage over a normal corporation. It makes quarterly cash distributions, similar to a dividend, but it doesn't pay taxes on them. Master limited partnership status makes Cedar Fair's earnings 25 to 30 percent higher than they would be otherwise.

About 90 MLPs trade on the stock exchanges, and roughly a third including Cedar Fair are scheduled to lose their status in1998. There's a small chance, however, that some or all of these will be grandfathered and allowed to keep their tax advantage. Legislation to that effect has been introduced in the House. If Cedar Fair is not granted grandfather status, it will become a regular corporation and will be taxed accordingly.

But when you consider that the average stock on the S&P; 500 has a p/e ratio of 15, Cedar Fair is already selling at a 30 percent discount to the market. Looking at it this way, the stock has already suffered from the drop in earnings that won't occur until 1998, and maybe not even then. It's as if investors have decided that 1998 has already happened, ignoring the fact that Cedar Fair has three years of tax breaks ahead of it. Meanwhile, the cash distribution gets bigger every year. In 1995, the expected payout is $2.40 to $2.45 a share, a yield of more than 8 percent on the current stock price.

Cedar Fair has several advantages that go beyond being an MLP and are again apparent to anybody who reads the reports. The three parks attracted 5.9 million visitors in 1994, so they haven't begun to saturate the market of 65 million people. Cedar Pointis famous for its macho roller coasters, but it's been adding kinder, gentler rides for aging baby boomers and their young children.

Moreover, competitors won't come in to knock them off. You don't see entrepreneurs lining up to build $500 million amusement parks in cold climates. Cedar Point can make a living by staying open four months a year, but that's because the infrastructure is already there. Anybody who starts from scratch will go someplace warm, where tickets can be sold year-round. Not one new park has been constructed in the Midwest in more than 20 years.

Finally, the company can grow its earnings by adding new rides. That's been Cedar Fair's strategy all along. Cedar Point is already in the Guinness Book of Records for most roller coasters (11) in one location, and its Magnum XL-200 was voted Best Ride on Earth by readers of Inside Track magazine, whoever they are. But management isn't resting on these laurels. Last year, Cedar Point unveiled Raptor, the world's highest, steepest, and fastest inverted roller coaster. It flips upside down six times per trip. This year, the park is doubling the size of Soak City, a cluster of water rides.

Cedar Point now has enough flumes, roller coasters, and other amusements that a day in the park isn't enough time to take the mall in. This creates overnight traffic for the hotel, where an extra 200 rooms are being added to the existing 300. Whatever works at Cedar Point is repeated at the other locations. There's a Snake River Falls at Dorney, where it's called White Water Landing, and a Berenstain Bear Country at all three parks.

If Dorney has its expected growth spurt, it will boost Cedar Fair's earnings for the next five to ten years. At that point, Cedar Fair can acquire a fourth park and maintain the growth rate that way. And there's always the chance that somebody bigger will come along and buy out the entire operation. Disney might be a likely candidate, or PepsiCo, the parent company of TacoBell, Pizza Hut, and Kentucky Fried Chicken. Think of all the Pepsis, pizzas, tacos, and chicken wings Pepsi could sell if it had its own amusement parks. It could install a Pepsi coaster fizz flume.

In sum, Cedar Fair has everything you'd hope to find in a long-term investment: a solid franchise in a growing business that lacks competitors and that every person over the age of six can understand. I've owned shares since 1987, and bought more late last year.

Over the past decade, 40 million people have visited a Cedar Fair park, seen the crowds, and watched the new rides going up. How many of these 40 million went home, though, and bought shares in the Uruguay Fund, or the Bangladesh Fund, or the Emerging Markets Infrastructure Opportunity Fund, or the High-Yield Inverse Floater Government Guaranteed Bond Fund, or a biotech stock they knew

nothing about, ignoring a great company with a proven record that pays an annual cash distribution of 8 percent plus and has a story that's easy to follow?

Here's a lesson from Lynch 101 that I never turn down a chance to repeat: No investor can expect to be an expert in hundreds of stocks, but it's possible to become an expert in four or five that are easy to follow and monitor their progress and buy more shares when the opportunity arises. Cedar Fair is a prime candidate.

The best part about being a Cedar Fair shareholder is doing the on-site research. In 1991, my wife, Carolyn, and our oldest daughter, Mary, thoroughly investigated the flume rides at Valleyfair. In 1992, all five of us tested the roller coasters at Cedar Point. In 1993, Carolyn and our middle daughter, Annie, did a complete examination at Dorney. The company's stock symbol isn't FUN for no reason.

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KEYWORDS: Stock Investing Strategies

95/04-The Current Thinking

It's been distinctly unrewarding to own electric utilities lately. But that will change__any decade now.

By Peter Lynch

In the past couple of years, I've fielded a lot of anxious questions about electric utilities from investors. They thought they were being conservative when they bought these low-risk stocks, so it was a shock to see them drop faster and further than a lot of the high-risk stocks. Today, the Dow Jones Utility Average hovers around 200, 10 percent below its high of 220 in 1986. Over ten years, this group has gone backward. People want to know if there's something fatally wrong with these companies.

I was mulling this issue when I sat down in January at the annual session of prognostication known as the Barron's Roundtable.

Jim Rogers was sitting directly to my right. This is the man who rode a motorcycle 65,000 miles around the world and lived to write a fascinating book about it, Investment Biker. You'd expect Jim to get excited about Iranian stocks, Ghanaian stocks, and real estate on the Turkish border, but there he was, touting the stodgy domestic utilities. He hasn't been shy about buying these. He owns about half of the hundred that are publicly traded

Rogers's enthusiasm is based on simple supply and demand. As individuals, we're not using as much electricity as we used to, thanks to more efficient refrigerators and air conditioners and people turning off the lights. But overall demand is still rising, at least 1 to 1.5 percent a year in the U.S. On the supply side, nobody has built a major electric plant anywhere in the country in two decades. What company wants to face the protesters, the lawyers, the cost overruns, the haggles with regulators?

So the plants we've already got aren't getting any younger, and many of the nuclear reactors are wheezing their way closer to retirement.

The point Rogers makes is that it won't be long before the older plants are unplugged and we'll have a power shortage in this country. In his experience, whenever there's a shortage of anything, the producers raise prices and make bigger profits, and bigger profits push the stock prices up. "I'm usually early about these things," he says. But he can sit back and collect the hefty dividends on his utility shares while he waits.

I speak to utility analysts and read their reports from time to time, but lately I haven't seen many reports that you could call enthusiastic. The prevailing view is that Jim's power shortage won't occur in this millennium. Many utilities generate more electricity than they need, and they've actually upped their production without building huge new plants. Joan Bok, the chairwoman of the board of New England Electric, tells me her company is planning to refurbish an existing plant, which will add 6 percent to its total output. What the company doesn't make itself, it can buy from Canada with its abundance of hydro generators. And as for nuclear plants being decommissioned, Bok says it won't begin to happen until 2002, and for some facilities not until 2033.

One way or another, there's more than enough voltage to go around, which brings us to the utilities' biggest headache: customer defections. A law the utilities would rather do without, passed in 1992, gives industrial users the right to shop around for the best price. Ford Motor doesn't have to get its juice from Detroit Edison. It's free to negotiate with other utilities that might offer lower rates. And if Ford can make a better deal in Wisconsin, Detroit Edison still has to deliver the power over its own lines.

This is called "wheeling," a form of deregulation that's great for industrial customers but puts the utilities in a bind. They can lower their rates to match the competition, which will cut into profits, or they can keep rates high and lose business to the competition, which will cut into profits.

And if they try to raise rates on the residential customers to make up for what they've lost from the industrial defectors, they'll have a consumer revolt on their hands. The regulators will never approve it.

It's the same predicament the regional phone companies are facing, except the Bells have an advantage. The money they lose in their rate wars, they can make back by cutting costs. Also, people are adding more phones and using them more often, which boosts the revenues of the phone companies. The electric utilities have a harder time finding costs to cut. They can't replace thousands of operators with machines, because they don't have thousands of operators. They've made a giant investment in expensive equipment that needs constant repair. As appliances get more efficient, their customers will use less electricity.

Last year's 20-percent-off sale in the utility sector is not a once-in- a-lifetime event. There's a sale of some kind whenever interest rates go up, because high rates make these dividend-paying shares less attractive. In 197174, the Dow Jones Utility Average dropped 57 percent, but it came back, eventually, in spite of the dire predictions about nuclear meltdowns and imminent bankruptcies. In the meantime, if you bought near the bottom, you were buying good companies on the cheap. A similar situation exists today, and there's no reason to doubt we'll see a comeback sooner or later.

The biggest difference between 1971 and 1995 is that utilities in 1995 are losing their monopolistic advantage, which means you have to be careful about which ones you buy. The important factors are as follows:

Payout Ratio. You can't invest blindly in the power company that pays the highest dividend, because in today's competitive environment, it may have to cut the dividend to survive. In 1994, six major utilities did just that, and more cuts are likely to come. The danger sign is a high payout ratio. That's the percentage of earnings that goes to paying the dividend.

A company that's paying 100 percent of its earnings in dividends could be in a tight spot. If earnings decline, the dividend can't be maintained. On the other hand, a company that pays out 80 percent of its earnings in dividends has a comfortable cushion.

The investor-relations person at any utility, or any brokerage-house utilities analyst, can give you the payout ratio of a utility. Or you can calculate it yourself by dividing the annual dividend by the annual earnings. A company that pays $1 in dividends and earns $2 per share has a ratio of 50 percent. Eighty-five percent or below is considered safe. Above 90 percent and you may be in the danger zone.

Cost of power. Utilities that borrowed billions of dollars in the 1970s and '80s to build expensive nuclear plants, some of which never got their operating license, obviously have more bills to pay than utilities that stuck with gas or coal. Where low-cost producers can generate a kilowatt of electricity for three or four cents, the high-cost producer might be spending as much as 15 cents.

There's no simple calculation you can make to determine whether a company is low cost or high cost, but if your brokerage firm has a utilities analyst, you can find out from him or her. Two low-cost producers on several analysts' buy lists are PacifiCorp(NYSE: PPW) and American Electric Power Company (NYSE: AEP).

The industrial-residential customer ratio. Since it's the industrial customers who are shopping for lower rates, the safest utilities to invest in are those with a high percentage of residential and nonindustrial customers. A good benchmark is 75 percent.

Location. Electricity can't be shipped more than a few hundred miles, because beyond a certain point, too much gets lost in transmission. So gluts and shortages are more regional than national. In the Southeast, where supplies are relatively tight, utilities will have an easier time holding their rates up than in the Southwest, which now generates more power than it needs. Hawaii has a natural protection from competitors: 2,500 miles of ocean makes it wheel-proof.

Cash and miscellaneous assets. Twenty years ago, utilities plowed their excess cash into construction projects. They borrowed heavily and issued more shares to raise the billions they needed to build new plants. They were plant-rich and cash-poor. Since they've stopped building plants, they've been building up cash, and some have more than they know what to do with. They've gone out and bought everything from savings and loans to insurance companies. In January, Minnesota Power & Light bought a company that holds auctions for used cars

A Texas utility, Houston Industries, bought a cable-TV business, which it recently agreed to sell to Time Warner for $2.25 billion. It's planning to use the proceeds to pay off debt and buy back millions of its own shares.

This could be terrific news for shareholders. Soon there will be fewer shares outstanding, which automatically increases the earnings per share and improves the payout ratio, since there will be fewer dividends to pay out.

It's always been a good strategy to invest in companies that buy back shares. Several other utilities are using their excess cash in this fashion. The list includes Pacific Gas & Electric , Dayton Power &Light;, and Florida Power and Light. Southern California Edison recently announced a buyback, too.

The table on page 34 lists ten utilities that have raised dividends ten years in a row and have relatively safe payout ratios. Those shown in italics are considered low-cost producers. Among the top utilities analysts I contacted for this article, Barry Abramson at Prudential recommends Duke Power, LG&E;, TECO, and SCANA. Michael Temple at Duff & Phelps likes TECO, Consolidated Edison of New York, and Central & Southwest. Ernest Liu at Goldman Sachs rates Duke Power and LG&E; as "outperformers," one notch below Goldman's highest rating, "Buy."

Even if Jim Rogers has to wait until the next millennium to see his prediction come true (and that's only five years away), some utilities are likely to do well. In the meantime, it gets my attention that nearly 70 percent of the shares in this industry are owned by individual investors, and 30 percent by the pros and the institutions, whereas with most stocks, the percentage is reversed. The fact that utilities have been underweighted in the pension funds and the mutual funds is promising in itself. The pros wouldn't be shunning this industry if they didn't expect the worst. So if anything good happens and they get more encouraged, there's always the chance they'll start a buying stampede.

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95/05-Bet the Houses

Fannie Mae is misunderstood, underappreciated, and undervalued. But don't pity this company. Buy it.

By Peter Lynch

In the stock market, no less than in police work, there are cases of mistaken identity. Once in a while, a reliable company with a steady source of income gets stuck in the line-up with the known gamblers, companies that are in cyclical industries and therefore have unpredictable incomes. Being thrown in with the gamblers can have a depressing effect on the stock price.

One of my favorite victims of mistaken identity is Fannie Mae (NYSE: FNM), formally known as the Federal National Mortgage Association. I've recommended the stock for a decade and owned it all along, and I'm still recommending it even though the price has risen from the single digits into the $70s. That's because it's still cheaper than it would be if Fannie Mae were correctly understood. For ten years, it's been a reliable earner that can't shake the image of being unreliable, so the stock sells at a low multiple to earnings

Through seven years and one recession, Fannie Mae has turned in 28 consecutive quarters of record earnings. If you covered up the name on the chart and asked the nearest Wall Street analyst what company produced these results, he'd probably say Wal-Mart or Home Depot. The difference is that Wal-Mart's stock is priced at 17 times earnings in today's market, whereas Fannie Mae is priced at 9 times earnings. It's a $75 stock that could easily become a $100 stock, overnight, if Fannie Mae started using an alias.

Fannie Mae is a former government agency that was privatized and first sold its stock to the public in 1968. It's the world's foremost owner and handler of mortgages. It buys them by the thousands, then bundles them into packages. Thanks to FannieMae and its close relation, Freddie Mac (the Federal Home Loan Mortgage Corp.), mortgages have become a commodity like barrelsof oil or bushels of wheat. Banks and S&Ls; no longer hold onto mortgages the way they once did. They sell them to FannieMae to be packaged, then use the proceeds to make more loans.The result is that mortgages are easier to get, and you and I pay cheaper rates. When banks or S&Ls; want to own mortgages,they simply buy one of the packages. There's a very active market for these so-called mortgage- backed securities.

Fannie Mae has been a great success as a private enterprise. It pays $1 billion in taxes annually, whereas if it were still part of the government, like the Federal Housing Administration, it would be sopping up taxes. The FHA is also in the mortgage business, but Fannie Mae with its 3,500 employees does twice the volume of the FHA with its 5,400 employees. It makes you root for the FHA to be privatized, along with the post office.Imagine the post office run by Fannie Mae, delivering the mailat peak efficiency and sending $1 billion a year back to the Treasury.

The reason Fannie Mae gets lumped in with the unreliable earnersis that it used to be one. The old Fannie Mae was more like GM or Chrysler: rags to riches and back again. It borrowed moneyat short-term rates and invested in mortgages that paid long-termrates. This worked fine as long as short-term rates were lowand long-term rates were high as long as the yield curve wasnormal, in other words. But when short-term rates went up, FannieMae would bleed red ink. At one point, it was borrowing moneyat rates that varied from 12 to 16 percent while holding mortgages yielding 7 to 11 percent.

In the early 1980s, Fannie Mae changed its strategy. The average mortgage lasts about seven years, so Fannie Mae decided to pay for its mortgages by selling bonds of an equivalent maturity. If it could earn, say, 10 percent on a mortgage and pay 9 percent interest on the bonds, it would lock in a 1 percent profit for the seven years

Now Fannie Mae was borrowing long and lending long. This was more expensive than borrowing short, but it removed the risk of rising rates. Fannie Mae also removed the risk of falling rates by making its bonds callable, which means it can redeemthe bonds at will. So when millions of homeowners refinance their mortgages at lower rates, as they did in 1992, 1993, and 1994. Fannie Mae can refinance its bonds at lower rates and maintain its spread.

It other words, Fannie Mae is no longer interest-rate sensitive. By borrowing long and issuing callable debt, it has lessened its earnings in the short run and given up the chance of making the occasional killing when interest rates go its way. But it has proved it can make a steady profit on rising rates, as in1994; falling rates, as in 1993; and recessions, as in 1990–91.This is the kind of company that Wall Street loves to own: a10 to 15 percent grower that's reliable. Yet a lot of people can't seem to stop worrying about Fannie Mae long enough to appreciateit. Interest rates go up, they sell the stock. Interest rates go down, they sell the stock. Saddam invades Kuwait, they sellthe stock. The dollar falls, they sell the stock.

There's no such thing as a worry-free investment. The trickis to separate the valid worries from the idle worries, and then check the worries against the facts. Since Fannie Mae has reinvented itself, the facts have been easy enough to check.

Remember the headlines six years ago, when people were worried about the collapse in real estate? A big drop in housing prices would seem to be a disaster for Fannie Mae, which owns billions of dollars' worth of mortgages. As it turned out, the prices of fat-cat houses were declining, but the prices of the vast majority of modest houses held up. In fact, the median priceof a house has been on the rise for 27 years, ever since the statistic was first published. It comes out every month. So all you had to know was that Fannie Mae didn't have anything to do with fat-cat houses, and that its average mortgage was $80,000, and you would have ignored the dire predictions and held on to the stock.

Five years ago, people were worried about the recession and how millions of workers would lose their jobs and default on their mortgages. In the oil-patch recession of the mid-1980s, thousands of homeowners walked away from their loans and sent the keys back to the bank. This hurt Fannie Mae, but it learned its lesson and tightened its credit standards. Throughout the1990 recession, when 2 million people did lose their jobs and banks such as Citicorp were reporting delinquency rates of 3 percent or more, Fannie Mae's delinquency rate was negligible less than 1 percent. The company passed the recession test. Today,its delinquency rate has fallen to 0.57 percent, an all-time low. The company publishes this data every quarter, so you and I can keep track of it.

By the end of the recession, people were worrying that the babyboom was over and that soon we'd have fewer people buying houses and taking out mortgages. But halfway into the 1990s, we've hadthe highest population growth since the 1950s and the highest immigration levels since 1910. Even if we did enter a period of zero growth in the housing market, the mortgage market could still grow. That's because of all the older homeowners in this country who paid off their mortgages long ago. When they sell their houses to move into condos or the Great Beyond, the buyers of those houses will be looking for mortgage loans.

Fannie Mae and Freddie Mac (I'm a shareholder in Freddie Mac,too, and I recommend it) already control 40 percent of the U.S.mortgage market, either as owners or as packagers. Mortgage-backed securities didn't exist 25 years ago, when Freddie Mac invented the idea and Fannie Mae followed. Today, this is a trillion-dollar business, most of it divided between Fannie and Freddie. Year by year, the two pioneers are capturing an ever-greater share of all mortgages.

The latest worry is that the government will meddle in FannieMae's affairs by imposing fees and restrictions, or by taking away some of its business the way it has with Sallie Mae (the Student Loan Marketing Association). But that's not likely to happen. In 1992, Congress passed a law that set higher standardsfor Fannie Mae and Freddie Mac and required them to strengthen their capital reserves. They've done so and today are the mainstays of our housing-finance system.

As I write this, Fannie Mae is sitting on $40 billion of surplus cash, half of which could be invested in mortgages. The old FannieMae would have put that money into mortgages right away, to boost profits immediately. The reformed Fannie Mae is holding back,waiting to lock into a better spread. This strategy has put adrag on earnings growth, which is why a lot of big-time investors and the so-called momentum players have been avoiding the stock. Once Fannie Mae puts this chunk of money to work, the growth rate will pick up again. Either way, the company will show its usual steady progress.

In June, investors will descend on Washington to hear FannieMae give what promises to be a favorable progress report. Eighty-five percent of the shares are owned by institutions, many of which will be there to get the good news in person. Average investors who do their homework in advance have a chance to get a jump on the herd.

I never believed in the efficient-market theory, which says that all the information about any company is reflected in the current price and that therefore the price is always rational.Fannie Mae, stuck in the lineup with the cyclicals and sellingfor a price-to-earnings ratio of 9, is all the proof I need that the market makes mistakes.

95/06-Golden Years

You don't need your own ingot, but the time may be coming when we'll all want to own a little gold

By Peter Lynch

No less a personage than Alan Greenspan once said that gold was the only refuge against profligate governments that are forever debasing their currency. He should know, I guess. These days we've been seeing a lot of debased currencies, including the good old U.S. dollar, and there's a whiff of inflation on Wall Street.

I won't try to predict when the whiff will turn into a rank breeze, but I'm sure about one thing: If it does happen, interestrates will rise and stocks and bonds will fall. In the high-inflation scenario, the only investors who get a good night's sleep arethose whose money is parked in a money market or deployed inhard assets such as gold. Some people keep 5 percent of their portfolios in gold at all times, as a kind of insurance policy. For years they haven't needed it, but the case for owning gold is more compelling today than it was a decade ago.

When the price of gold hit $800 an ounce in 1980, it was a signal for every would-be prospector on earth to grab a pick and shovel and head for the nearest Sierra Madre. No glint in a rock orfleck in a stream escaped attention: Creaky, old shafts were reopened; new holes were dug. South African gold production was in decline, but new mines in the U.S., Canada, Brazil, and Australia took up the slack.

Today, South African output continues to decline, and miners there are scraping the bottom of what was once the mother of all mother lodes. But the big news is that the newer mines that have opened up around the world are beginning to run out of gold as well. Many of these latter-day projects involve small deposits of ore, and they have short life expectancies. Moreover, 14 years of catatonic gold prices have dampened the enthusiasm of prospectors,so the search for new sources has been limited. There's beena definite sag in the supply line.

About 3.6 billion ounces of gold have been extracted from the earth since the time of the pharaohs. That may sound like a sizablehaul, but if you took all the gold in circulation today jewelry, bars, ingots, coins, fillings, crowns and melted it into onebig bullion cube, the entire world supply would easily fit onto the basketball court at the Boston Garden. The whole lump is worth about $1 trillion at today's prices, or only one quarter of the U.S. national debt.

If you divided the lump equally among the 5.6 billion inhabitants of the earth, everybody would get less than an ounce. But that's hardly enough to satisfy the growing demand for jewelry justin Asia and India, where billions of fledgling capitalists have money to spend and not much to spend it on. They can't buy a Winnebago, because the roads are too narrow, and where would they park one? In remote areas, they can't buy electric appliances, because there's no electricity. The last thing they want is to be stuck with the local currency, as long as their governments can operate a printing press. So they're buying as much goldas they can.

Jewelry sales have nearly doubled in the past decade, and 75 percent of the world's gold output now ends up as baubles, bangles,and beads. The U.S. is still the world's largest customer, but Chinese jewelry lovers are buying so much gold these days that China is running a close second. This surge in retail

buying would surely have driven up the price if it weren't for the central banks. They've been on a selling spree.

Since the days of the gold standard, when nations settled their debts with metal, the various central banks have kept stacks of gold bars in repositories such as the Federal Reserve Bank of New York, which has the largest supply of gold on earth more than any South African mine. From 1989 to 1993, central banks have been net sellers of gold, giving their governments something to live on while they watered down their own currencies. The governments are like their citizenry in this respect: They've been buying gold because they know the local money can't be trusted.

The Russians have been the most active sellers of gold, drawing down their stockpile to pay their international bills as they flood the country with worthless rubles. As much as the Russian selling has depressed the price of gold, the idea that they will continue to sell has depressed it even more. By one popular guesstimate,the Russians still have 2,000 tons to unload, while the Russians themselves have pegged their supply at a more modest 240 tons. Apparently, there is no way of knowing the exact amount, but in any event, the Russian selling has subsided.

Selling by central banks in general has subsided, from 500-plus tons in 1993 down to an estimated 46 tons in 1994. This, coupled with the growing popular demand and the dwindling supplies inexisting mines, has lifted the spirits of the gold bulls, more commonly known as gold bugs. These people have been waiting for a rally long enough for their children to grow up and leave home.

As to when we'll actually see an extended rally, your timetable is as good as mine, but I've got an idea of how you can get the most out of it when it happens. In the last big run-up in gold, the one that carried the price to $800 an ounce, the most popular way to play the rally was to buy gold coins and gold bars. People lined up at the coin stores to purchase the one-ounce Krugerrand. In those days, there was a widespread fear that the financial system was about to collapse, which is why so many investors opted for owning the metal, as opposed to shares of mining companies that traded on the stock exchanges.

I've never understood the apocalyptic theory of investing. If the world really does collapse, is it really going to do you any good to have a few Krugerrands in your pocket? And if it doesn't, you're much better off buying shares and not the metal. Gold coins and bars are heavy and take up space in the bank vaults, and there's always the chance they'll be stolen. If you buy them through a company that offers storage, they charge you for it. Physical gold never pays a dividend, the way shares routinely do. And the arithmetic of corporate earnings strongly favors investing in the stocks.

The back-of-the-napkin explanation is as follows: You buy anounce of gold at, say, $360 (a little less than gold's selling for as I write this), and the price does a high jump and hits $500. So you've made $140. That's a 39 percent profit from owning the metal. But look what happens when you buy shares in a mining company instead. Let's say for argument's sake that the mining company is making a profit of $20 an ounce on production when gold is at $360 an ounce. When gold hits $500, the company's profits suddenly jump to $160 an ounce. That's an eightfold increase in earnings.

When a company's earnings go up eightfold, even when Wall Street analysts are skeptical that the bonanza can continue, the stock price will double or triple. And if euphoria sets in and people start believing the price of gold can rise to $1,000 an ounce and beyond, the stock price of our would-be

mining company may well increase as much as eightfold, right along with the earnings. Even if it doesn't, you'll get a far better return than the 39 percent you'd get out of the Krugerrand.

Now we arrive at the usual problem: Which gold stocks do you buy? Mining companies are tough to figure out, so this is one of those cases where Lynch's everybody-can-do-it theory of stock selection doesn't apply. How sad it would be if you were right about gold, but then missed the benefit because you picked the wrong company.

It's smarter to go with a gold mutual fund. You'll get a diversified portfolio managed by somebody who knows more about mines than you do. There are 38 or so gold funds or gold-related funds, including 13 with ten-year records (see the table on the nextpage).

Looking over this latter group, I'm struck by two things. A few have done remarkably well, given the fact that the price of gold is stuck at the same place it was at the beginning of the period. If you owned Oppenheimer Gold & Special Minerals, you got a 228.56 percent total return over a decade. The average fund with a ten-year history gave you a 96.90 percent return, which doesn't beat the stock market but certainly beats the zero return from owning a Krugerrand or a gold bar.

The second striking thing about these funds is the wide range of performance. With the minus 22.59 percent return from Lexington Strategic Investments, you were better off owning the gold bar. Obviously, all gold funds are not alike. From what I can gather, the two losers onthe ten-year list (Lexington Strategic and Untied Services Gold Shares) were heavily invested in South Africa. For a variety of reasons, South African shares fare worse than their North American counterparts during periods when the gold price languishes. On the other hand, South African gold funds give you a big pop and outperform the others when gold begins to rise. Lexington Strategic Investments has recently done just that. It's been the top performing gold fund for the past two years.

Of the 38 gold funds, 7 are no-loads. One is an index fund (launched in 1988 by Benham) that tracks the total return of the Benham North American Gold Equities Index. So the usual homework you have to do when picking an individual stock, you need to do when picking a gold fund. I leave it to you to explore the details, but one thing is certain. If gold funds were able to give a mediocre performance in the years when gold went nowhere, they'll be spectacular performers if the metal takes off.

GOLD MUTUAL FUNDS

Fund Name 10-year return

Bull & Bear Gold Investors

91.95%

Fidelity Select Precious Metals

115.20%

Franklin Gold Fund

151.96%

Invesco Strategic Gold

21.74%

John Hancock Gold & Government; B

88.88%

Keystone Precious Metals

128.44%

Lexington Goldfund

136.34

Lexington Strategic Investments

-22.59%

Oppenheimer Gold & Special Minerals

228.56%

United Services Gold Shares

-16.44%

USAA Investment Trust Gold

29.85%

Van Eck International Investors Gold

133.48%

Vanguard Specialized Gold & Precious Metals

172.36%

AVERAGE

96.90%

Lipper Gold Fund Index

99.76%

Peter Lynch writes the Investor's Edge column with John Rothchild. Lynch is vice-chairman of Fidelity Management and Research and the coauthor, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon & Schuster.

95/08-Free at Last

Don't mistake a spin-off for a throwaway: Spin-off companiesoften outperform their parents.

By Peter Lynch

Imagine this scenario: you're a shareholder in Quaker Oats,because you think it is a good investment and you like the oatmeal.One day the mail brings free shares of Fisher-Price, a QuakerOats subsidiary that's now being turned loose as a separate company.You call your broker to ask how Fisher-Price is doing. You findout it has been losing money for several quarters, so you thinkto yourself, Why keep this dog? You sell the shares as soon asthey start trading, and you are happy to receive $11 for each.After all, you got them for free.

A couple of years later, you're browsing through the stock pages,and you come across Fisher-Price. Those $11 shares have become$38 shares, and you wish you hadn't noticed it, because now yourealize you missed a chance to more than triple your money onthe giveaway, while Quaker Oats (which you still own) is up amodest 10 percent.

When a subsidiary or a division is booted out of the nest ofa parent company, it's called a spin-off. Lately, we've seena lot of these. After decades of trying to diversifyÐor as Icall it, diworsifyÐmany companies are returning to their coreoperations. The buzzword for this is "rightsizing." If a divisiondoesn't fit in with a company's main line of work, the companysells it or spins it off.

A spin-off happens in two stages. First, the parent companyissues stock in the offspring and sells a small percentage ofit in a public offering. The rest is distributed as a gift (oftentax free) to shareholders of the parent. What makes these dealsso intriguing is that spin-offs tend to do better than stocksin general, particularly in the first 24 to 36 months after theyget their independence. On the next page is a table showing someof the most impressive performers of the 1980s and '90s.

Two Wall Street analysts are making a career out of spin-offs:Barbara Goodstein at Rothschild and Patrick Cusatis at LehmanBrothers. Cusatis says he got the idea from reading my firstbook, One Up on Wall Street, which contains a short section onthe subject. I'm gratified that he paid such close attention.He traced 161 spin-offs going back as far as 1965 and made anintriguing discovery: 14 percent of these spin-offs became takeovertargets and ended up as divisions in other companies, usuallyin the same industry.

Fisher-Price is a typical example. This liberated toy companywas on its own for less than three years before Mattel snappedit up. It made no sense at Quaker Oats, but it was a fine complementto Mattel.

I look at a lot of numbers every week, but the 14 percent takeoverrate made an impression. With companies in general, the oddsof a takeover are only 3 to 4 percent, so the shareholders ina spin-off are three to four times more likely to benefit fromone of these potentially lucrative episodes. In a takeover, thestock price is a cinch to go up.

It's no accident that spin-offs have done well. The managersno longer take orders from above and cut costs in obvious waysthat the old regime overlooked (this is called grabbing the low-hangingfruit). They become more entrepreneurial. The parent companymay have a financial stake in the success of the spin-off. Certainly,it has an emotional stake. The last thing a parent company wantsis for one of its own projects to flop. So it tries to do everythingpossible to help the fledgling enterprise, from cleaning up

thebalance sheet to installing good management. A company that hasto jettison divisions in a fire sale to raise cash may not careabout the consequences, but a powerhouse like Coca-Cola certainlydoes.

Coca-Cola spun off Columbia Pictures in late 1987 (keeping a49 percent interest), and when Columbia proved to be a disappointment,Coke did what it could to turn things around. Then it found abuyer at a fancy price. In 1989, Sony acquired Columbia for $27a share, more than three times higher than where shares firsttraded.

The most complicated separation was the Baby Bells. If you owneda share in AT&T; in 1983, you got fractions of shares in sevenspin-offs at once. A lot of people thought this was a nuisance,but those who held on to their fractions were well-rewarded.The Baby Bells did the easy cost-cutting and had a great sixyears while AT&T; languished.

In many of these spin-off situations, you've got two forcespulling at the stock price from opposite directions. On one sideare the mutual funds that own shares in the parent but can'tget involved with the offspring. For instance, the S&P; Indexfunds must sell whatever shares they get from a spin-off if thenew company isn't in the S&P; 500. While the funds are dumpingtheir holdings, so are individuals who don't want to be botheredwith upstarts they know nothing about.

On the other side are buyers who understand the virtues of spin-offsand scoop up the shares at what they perceive to be bargain prices.This often results in a standoff that may last for several months,until the new company has a chance to prove itself and impressthe Wall Street kibitzers. Take Gardner Denver Machinery, a manufacturerof air compressors and blowers, which emerged from Cooper Industries in April 1994. The stock was stuck in a trading rut for nearlya year until it surprised the Street with better than expectedearnings. Only recently did Gardner Denver jump the rut.

Tandy is one of the champions of spinning things off, sendingso many divisions out into the world that its genealogy beginsto sound like the families of Levites from the Old Testament.In 1975, Tandy begat Tandycrafts and Tandy Brands, and the shareholdersgot free shares in both. Then, in 1976, Tandycrafts begat Stafford-Lowdon.Three years later, it begat Colortile, and in 1986 it begat InterTAN,one of the few losers in this crowd. Tandy Brands, meanwhile,changed its name to Bombay Company, which in 1991 begat TandyBrands Accessories. If you had invested $5,000 in Tandy in 1975and held on to the whole lot, you would have $86,000 by now.

The latest trend from the boardroom is for companies with twoor three giant divisions to divide themselves into equal parts.Usually, they take this action because they think investors havefailed to appreciate the true value of the sum of the parts.In other words, the stock price is too low. Thus, Sears spunoff Allstate, 80 percent of which will go to Sears shareholdersas a tax-free gift sometime this summer.

95/09-Fear of Crashing

Think the market's headed for a fall? No argument here--unless you think you know when, or that there's a better survival strategy than owning great stocks.

By Peter Lynch with John Rothchild

The Dow's passing 4700 has brought new worries about a nastycorrection. The worrying started as soon as we recovered fromthe last nasty correction, in 1990. There's no end to the listof probable causes for a repeat: Too many mutual funds are chasingtoo few stocks, stocks are overpriced, the dividend yield onthe Dow is at an all-time low, and-- this one is my favorite--notenough investors are worried.

Let me go on record with Lynch's prediction: Another big correctionis on the way. I'd bet the ranch on it, if I had a ranch. Itmay come this year, next year, or the year the Red Sox win theWorld Series (don't hold your breath!), but sooner or later,it will happen. You read it here first.

On what do I base this bold assertion? Stocks have declined10 percent or more on 53 occasions since the turn of the century.That's roughly one correction occurring every two years.* And on 15 of these 53 occasions, stocks have declined 25 percentor more. That's one nasty correction (also known as a bear market)every six years.

For all I know, another bear may have arrived on the scene bythe time this article reaches the newsstands. Or the equity godsmay wait until the Dow reaches 6500 before they decide to knockit back to 4700, today's highs becoming tomorrow's lows. Or we could drop from today's levels straight down to 3100.

Make no mistake: Corrections can be scary experiences. People lose confidence in the economy, in their portfolios, and in the companies in which they've invested. It's like a storm that rollsin and blackens the sky. Fear sets in.

If only we didn't have indexes--the Dow, the Standard & Poor's500, and so forth--that enable us to track the ups and downs of "the market," we'd never have this problem with corrections. Do you know what the range is between the high and the low priceof the average stock on the New York Stock Exchange in any given year? Fifty percent. So most stocks fluctuate 50 percent fromtop to bottom every year, without any fanfare.

We remember the 1000-point drop in the Dow from August to October1987, the scariest correction in recent times. But we forgetthe 1000-point rise in the Dow in the 11 months preceding thatdrop--a remarkably fast gain, considering that it had taken theDow four years to tack on the previous 1000 points. If we hadbeen sequestered like a jury during all of 1987, we would havecome out thinking the market was flat for the year, and nobodywould have panicked.

But we do have indexes and we are preoccupied with their upsand downs, so we will have scary corrections. If we tack on another 1000 points from here and the Dow rises to 5700 in short order,the chances of another big decline increase considerably.

Assuming you agree with my forecast, how can we prepare? Mostly by doing nothing.

This is where a market calamity is different from a meteorological calamity. Since we've learned to take action to protect ourselvesfrom snowstorms and hurricanes, it's only natural that we wouldtry to prepare ourselves for corrections, even though this is one case where being prepared like a Boy Scout can be ruinous.Far more money has been lost by investors preparing for correctionsor trying to anticipate corrections than has been lost in correctionsthemselves.

The first mistake is hedging the portfolio. Anticipating a dropin the market, the skittish investor begins to dabble in futuresand options, the kind of investment that will make a profit whenstocks decline. People think of this as correction insurance.It seems cheap at first, but the options expire every coupleof months, and if stocks don't go down on schedule, people haveto buy more options to renew the policy. Suddenly, investing isn't so simple. Investors can't decide whether they're rooting for stocks to falter, so their insurance will pay off, or fora rally, for the sake of the portfolio.

Hedging is a tricky business even the pros haven't mastered-- otherwise,why have so many hedge funds gone out of business in recent years?Hedge-fund managers have been sighted in unemployment lines.

The second and more prevalent mistake is the ritual known aslightening up. This time, our skittish investors, again fearingthe correction is imminent, sell some or all of their stocks and stock mutual funds. Or they put off buying stocks in companiesthey like and sit on their cash, waiting for the crash. "Better safe than sorry," they tell themselves. "I'll wait for the dayof reckoning, when all the suckers who didn't see this comingare wailing and gnashing their teeth, and I'll snap up bargainsleft and right." (But once the market reaches bottom, the cashsitters are likely to continue to sit on their cash. They'rewaiting for further declines that never come, and they miss therebound.)

They may still call themselves long-term investors, but they'renot. They've turned themselves into market timers, and unlesstheir timing is very good, the market will run away from them.

Market timing was quite popular about 2700 Dow points ago, whenclients of mutual funds were encouraged to switch back and forth from stock funds to the money market, thereby avoiding any unpleasant corrections. The signals were sent out by self-appointed heads of "switching services" who charged hefty fees (as high as 3percent a year) for their canny advice. People were paying their switch-fund advisors two to eight times as much as they paidin management fees to the funds themselves.

Whereas in most states barbers have to pass a test before theyare allowed to cut hair, there is no test for switch forecasters. My advice for anyone who is still paying for such a service: Go back and carefully check the results before you give anotherpenny to a switching service. Have you really avoided the corrections,or have you avoided the best months of the greatest bull marketin history? It pains me to think how many people have done thelatter.

A review of the S&P; 500 going back to 1954 shows how expensiveit is to be out of stocks during the short stretches when theymake their biggest jumps. If you kept all your money in stocksthroughout these 40 years, your annual return on investment was11.4 percent. If you were out of stocks for the ten most profitablemonths, your return dropped to 8.3 percent. If you missed the20 most profitable months, your return was 6.1 percent; the 40 most profitable, and you made only 2.7 percent. Imagine that:If you were out of stocks for 40 key months in 40 years, trying to avoid corrections, your stock portfolio underperformed yoursavings account.

The same computer that gave us that revelation also contributedthe following: If you invested $2,000 in the S&P; 500 on January1 of every year since 1965, your annual return has been 11 percent.If you were unlucky and managed to invest that $2,000 at thepeak of the market in each year, your annual return has been 10.6 percent.

Or if you were lucky and invested the $2,000 at the low pointin the market, you ended up with 11.7 percent. In other words,in the long run it doesn't matter much whether your timing isgood or bad. What matters is that you stay invested in stocks.

Recently, Forbes published its hit parade of the richest peoplein the world, and I was reminded that there's never been a market timer on the list. If it were truly possible to predict corrections, you'd think somebody would have made billions by doing it.

The fact that nobody has done so ought to tell us somethingabout our chances of dodging the drops. Warren Buffett weighsin at No. 2 on the Forbes list. He got there by picking stocksand not by switching in and out of them.

Buffett switched only once in his career, in the late 1960s,when Wall Street fell so hopelessly in love with a select groupof growth companies that no price was too high to pay for them.At the point of maximum silliness, McDonald's was selling for 83 times earnings and Disney for 76, whereas in saner times,they might sell for 20 times earnings. These two companies, and 48 others in the so-called Nifty Fifty, were so overvalued thatit took them ten years to catch up to their price tags. So ifyou're looking for more concrete advice than I've offered sofar, take a tip from Warren Buffett and get out of stocks that are selling for 83 times earnings. Otherwise, stay the courseand resist the temptation to outsmart corrections.

In telling you this, I'm assuming you're in stocks for the longhaul: two score years or beyond. Never invest money in stocksif you are going to need it for some other purpose in the foreseeablefuture. Twenty years is a reasonable horizon for investing. Thatought to be long enough for your stocks to overcome the worstof times, such as the stretch between 1966 and 1982, when theDow stumbled from a peak of 1000 to a nadir of 777 And here'sa reassuring point: When you include the dividends, stocks inthe S&P; 500 gave a total return of 75.37 percent during that depressing 16-year period, or 3.5 percent annualized. Thanksto dividends, corrections aren't necessarily as bad as they'remade out to be.

As soon as you realize you can afford to wait out any correction,the calamity also becomes an opportunity to pick up bargains.

The table on page 83 shows a few examples of how the four nastiest corrections in recent history (1973-74, 1981-82, 1987, and 1990) actually paid us a favor by giving us the chance to buy greatcompanies at fire-sale prices. If it's happened before, it will happen again.

THE ANATOMY OF A CORRECTION

How have different types of companies fared in those four corrections?Do all stocks correct equally? To answer those questions, I enlistedthe help of Deborah Pont, my dogged researcher at Worth, whoin turn enlisted the help of Standard & Poor's, the Frank RussellCo., and Safian Investment Research. Together, we came up witha large table (on the next page) involving four broad categories,each represented by an index. Large companies are representedby the S&P; 500; small companies by the Russell 2000; growth companiesby the Safian growth index; and cyclical companies by the Safian cyclical index.

It's obvious from these numbers that growth companies were thestar performers during and after two of these corrections, andthey held their own in the Saddam Hussein correction of 1990.The only time you wished you didn't own them was 1973–74, whengrowth stocks were grossly overpriced, as we've already mentioned.

For those who haven't boned up on the subject, a growth company is a steady performer that can prosper in all economic conditions, as opposed to a cyclical, which lurches from rags to riches and back again. A typical lineup of growth companies includes those that make software and soft drinks, drug makers and fast-food chains, specialty retailers and service-related businesses, and even a cigarette manufacturer, Philip Morris. Sam Stovall, editor of Standard & Poor's Industry Reports and an avid student of corrections, calls these the "eat 'em, drink 'em, smoke 'em,and pay-for-it-by-going-to-the-doctor type stocks."

After the infamous 1987 bear market, when investors in the Dow industrial stocks were traumatized by a 33 percent loss from the August top to the October bottom, including the terrifying 508-point one-day drop, investors in growth stocks were still ahead by 8.5 percent and getting a good night's sleep. In 1990,growth stocks lost a bit more ground than the cyclicals on the downside but far less than the three other categories of stocks, and they've kept pace with the cyclicals on the upside.

I've long been a fan of growth companies, but in the courseof collecting data for this article, I was amazed to discoverthat since 1949, an investment in the 50 growth stocks on Safian's list has returned over 230-fold, while the cyclicals have returned only 19-fold. Whether they are owned individually or as an elementof mutual funds, growth stocks have given their owners fewer heartaches and many happy returns.

THE CASE FOR ZERO PERCENT BONDS--THAT IS, YOU SHOULDN'T OWNANY

This brings me to an investment strategy I described in my second book, Beating the Street. If I convince you of its merits, you will never again buy a bond or a bond fund, and you'll stay fully invested in stocks forever.

There are two main arguments for owning bonds: They give you income so you can pay the bills, and they add ballast to your portfolio. Unless you're talking about bonds of the short-term variety (two to four years), the ballast argument is false. Long-term bonds can be almost as volatile as stocks. They have their own corrections: When interest rates go up, bond prices go down Justas fast as stock prices. If you're not willing to hold a bond to maturity, you're exposing yourself to potential losses, the same as in stocks. And bonds have no upside to reward you for this risk if they're held to maturity. You collect the interest along the way, but in the end, the best you can hope for is to get reimbursed.

In the nine decades in this century, bonds have outperformed stocks only once--in the 1930s. They came close in the 1980s,but in the first half of the 1990s, stocks have once again proved their superiority. People are living longer these days, so many retirees who buy bonds for the income are discovering that they may end up needing more money than they thought they would. They could use some growth in their principal, but they aren't getting it.

The strategy I'm proposing can offer the best of both worlds: money to live on that normally comes from bonds, and growth that comes from stocks. Here's how it works. You sink 100 percent of your investment capital into a portfolio of companies that pay regular dividends. You could do this the easy way and invest in an S&P; 500 index fund, currently yielding about 3 percent. Or you could select a few "dividend achievers," as identified by Moody's. These are the companies that have a habit of raising their dividends year after year no matter what.

According to the latest Moody's list, no fewer than 332 publicly traded companies have accomplished this for at least ten years in a row. The list includes some obscure names but also a lot of familiar ones, the likes of Wal-Mart, Hasbro, Philip Morris, and Merck. (To get a copy of the Handbook of Dividend Achieversf or $19.95, call Moody's at 800-342-5647, extension 0546.)

Since dividends are paid out of earnings, these dividend achiever scouldn't have compiled such a record without having enjoyed consistent success in their core business, whatever it is. So you're looking at a group of profitable enterprises with staying power.

Let's say you've got $100,000 to invest for the long term, and you need an income of $7,000 per annum to make ends meet. Youc an get it by purchasing a 30-year bond paying 7 percent. But instead, you take Lynch's advice, shun the bonds, and build a portfolio of stocks that pays you a 3 percent dividend. In the first year you get $3,000 in dividends. Since you need $7,000to live on, you're $4,000 short on the income side, but that can be solved. You sell $4,000 worth of stock.

It may sound crazy to be selling shares that you bought 12 months earlier, but bear with me. Let's assume the prices have gone up 8 percent, which is the historical norm for stocks. (Overtime, stocks return 8 percent on the price gains and 3 percent on the dividends, for a total return of 11 percent.) Between the dividends and the price gains, your portfolio would be worth$111,000 after the first year if you left it alone. But you don't. You take out the $3,000 in dividends and you sell the $4,000chunk of stock. After putting this $7,000 in your pocket, you begin year two with $104,000 in the account.

You can see from the table on the next page what happens next. The companies in which you've invested raise their dividends as usual, so in the second year, the portfolio gives you an income of $3,120. At the end of year two, you have to sell only $3,880worth of stock to reach your $7,000 goal. Every year thereafter, as dividends are raised and stock prices go up, you're selling less and less stock to cover your expenses. In year 16, you receive$7,000 out of the dividends alone, and from this point forward, you never have to sell a single share to get the customary payout. In fact, your payout goes up.

These numbers are theoretical, but they're based on the average returns from stocks and dividends over this entire century. Assuming these same results hold for the future, after 20 years, your original $100,000 will have grown into $349,140. You'll be more than three times richer than when you started, on top of the$146,820 worth of dividends you've spent along the way. By taking the bond route, you would have received $140,000 in interest and gotten your $100,000 back.

If this dividend strategy is such a great idea, why aren't more people taking advantage of it? I suspect it's the same reason they own more bonds than stocks ($9.4 trillion to $6.5 trillion, at current count) when stocks are clearly more profitable overtime. They think they're jinxed. They're worried about the next nasty correction, and they're convinced it will happen the day after they invest in stocks. Perhaps you count yourself as one of this unlucky crowd.

The best way to cope with the fear of crashing is to assume the worst and examine the results. Let's assume, then, that you are jinxed, and the day after you invest your entire $100,000 in dividend achievers, the market has its worst session in history and your portfolio loses 25 percent of its value overnight.

Fidelity's Bob Beckwitt ran the numbers. In spite of the immediate25 percent loss, if you stuck with the plan, sold shares to augment the return, and collected your $146,820 in dividends along the way, at the end of the 20th year your portfolio would be worth$185,350. That's not as good as $349,140, but it puts you $85,350ahead of the $100,000 bond.

Let's imagine an even more terrible case: a recession that lasts 20 years. The country is in its worst slump since the Great Depression. In this prolonged crisis, companies struggle to increase their profits, and instead of share prices and dividends increasing at the normal rate of 8 percent and 3 percent, respectively, these returns are cut in half. Still, if you stuck with the program and removed $7,000 from the account each year, you'd end up with a $100,000 portfolio--exactly the same as getting your principal back from a bond.

Again, these calculations are theoretical, but the results areso favorable to stocks that there's a lot of room for error.Everybody can be unlucky, the whole country can be unlucky, andstocks will still do better than bonds--assuming you keep yourmoney in stocks for 20 years or longer. This is where male retireeswill say: "I don't have 20 years to wait, because I'm 65 alreadyand my life expectancy is 68.2. I only have 3.2 years to live."In fact, if a man gets to 65, he's likely to make it to 85, andif he and his wife both reach 65, there's a good chance one ofthem will make it to 90. People have more time than they thinkto ride out corrections, which is the main reason we shouldn'tbe worried about the next one, or the one after that.

I'll leave you with the latest gloomy report from Wall Street:Experts say stock prices will collapse because too many peoplehave become long- term investors. The way they see it, the ideaof long-term investing is so popular, it has to be wrong. Doesthat mean the earth really is flat?

* In spring 1994, we had a stealth correction. The Dow dropped10 percent from its January 31 high on three separate occasions,managing to recover its losses before the end of the tradingday in each instance. Few people took notice, but maybe that'swhy 1995 has been such a good market: The semiannual declinehas already sneaked past us.

ASK YOURSELF: WHY DO I OWN THESE COMPANIES?

When a correction hits and people around us are losing theirheads, as Kipling would say, we can find reassurance in the following:What makes stocks valuable in the long run isn't "the market."It's the profitability of the shares in the companies you own.As corporate profits increase, corporations become more valuable,and sooner or later, their shares will sell for a higher price.Historically, corporate profits have advanced by 8 percent ayear. This 8 percent, along with the 3 percent dividend yield,is what

accounts for the 11 percent annual return. There maynever have been a year when they had a total return of exactly11 percent, but that's the average over time. Corrections orno corrections, that's what stocks produce, because that's whatcorporations produce.

Even if corporate profits grew at 6, 5, or 4 percent, stockswould still advance, albeit at this lower rate. Adding in the3 percent for the dividends, you'd get a 9, 8, or 7 percent totalreturn. That's still a better return than you'd get from bondsin most decades. Ultimately, to be an investor in stocks, youhave to believe that American business has a decent future, aswell as business worldwide, and that corporations will continueto increase their profits. If you are as convinced of this asI am, then you'll never panic in a correction. --P.L.

95/10-Still Tough to Beat

Some thought this investment opportunity was too good to last. They were wrong. The local S&L; is still a heck of a place to put your money.

By Peter Lynch

When last we looked into it, investing in the local savings and loan when it went public was the closest thing to printing money that ever came a stock picker's way. Between 1991 and 1994, some 300 new S&Ls; issued shares that gained an average of 30 percent on the first day of trading and 60 percent within three months, on their way to doubles, triples, and even a few quadruples. (It's also remarkable that fewer than a handful of these are trading below their offering prices.) But in early 1994, regulators put a temporary stop to this bonanza.

What created the bonanza in the first place was a quirk in the way these institutions took shape. Founded many decades ago (and in many cases a hundred years ago), America's thrifts were organized along the lines of a co-op. They were run for the benefit of depositors, but they weren't owned by anyone in particular.

So when the thrifts (the term covers S&Ls;, mutual savings banks, and some other creatures) began to go public, there were no previous owners to pay off, as happens in most public offerings. Instead of a big chunk of the proceeds ending up in the pockets of the company's founders, all the money was returned to the company till.

For the lucky buyers of the shares, the result was the same as buying a new car for cash, then discovering that the dealer has left the cash in the glove compartment as a car-warming present. Let's say the local S&L; had a book value of $20 million, the result of decades of earnings built up inside the company. Then it went public and sold $20 million worth of shares in the offering. That $20 million invested by the shareholders became their thrift-warming present to themselves; in effect, they were buying the business for nothing. And because their $20 million was injected into the S&L;, the book value doubled overnight, from $20 million to $40 million. Theoretically, each share was now worth twice as much as the investors had paid for it.

This explains the big "pop" on opening day, when the newly issued shares began to trade on the stock exchanges. The price almost always took a jump to catch up to the fact that the value of the company had doubled in the act of going public. There were no former owners to cry foul, as they surely would have in a traditional offering had their company been sold for half price to public buyers who stood to make a greater profit than the previous owners.

In these hundreds of thrift "conversions," as it's known when a thrift goes public, every person with a savings account in the institution was invited to buy shares at the initial low price! Twice in the past four years (in a column and a Worth cover story), I attempted to describe the merits of investing in S&Ls; as they went public or, for that matter, investing in S&Ls; that had already gone public and were still selling at what seemed to be bargain rates. Reviews of the publicly traded thrifts I suggested researching last year and in 1992 are shown on this page.

Sadly, only a small percentage of depositors nationwide took advantage of the opportunity to buy shares in the public offerings in their own neighborhoods. The vast majority of the shares (98 percent by some accounts) were scooped up by professional investors who roamed the country opening savings accounts so they would get the right to participate in as many conversions as possible. The loyal customers who had maintained savings accounts at the local S&L; for decades turned their backs on these deals while the outsiders took home the spoils.

There were a few notorious cases where the managers and directors of the local thrift gave themselves an ample supply of free stock or stock options going into a conversion. To stop this profiteering, the Office of Thrift Supervision slapped a moratorium on conversions in early 1994. As soon as the moratorium was announced, a chorus of industry watchers proclaimed that the game was over, but four months later the moratorium was lifted.

Once again, the regulators would allow conversions, subject to new restrictions. Insiders could no longer reward themselves with bushelfuls of free shares and options, and the underwriters who took these companies public were pressured to raise the offering prices to take some of the pop out of these stocks

Though the game wasn't over, it had definitely changed. In 1994, 100 thrifts went public. The stock prices of the 68 that traded on Nasdaq gained 17 percent on average on the first day, but by the end of the year, they were up only 16 percent.

There were two reasons for this disappointing performance: a lackluster stock market in late 1994 and the confusion surrounding the new regulations. Since that confusion has now been resolved, the 1994 conversion class is up 48 percent from the initial offering prices. The table on page shows the top-performing thrifts that went public in 1994, as of mid-1995. [Tables and graphs are not included in the Worth OnLine archives.]

For last year's article ("Bank on It," April 1994), the staff at SNL Securities, a Charlottesville, Virginia, research firm that is our favorite authority on the subject, gave us the names of 100 thrifts that were not yet public but were likely candidates for eventual conversion. Eight of those have converted thus far, with an average one-day pop of 18 percent and an average gain of 34 percent as of this writing. Seven more thrifts on that list have conversions pending

In 1995, we've seen 53 thrifts go public, with an average gain of 14.7 percent on the first day of trading and 27 percent after three months. These results don't quite measure up to the bonanza of years past, but a 27 percent gainin just 90 days is a better return than you'd get from a savings account in five years.

One reason for the return of the bigger pops is that shares in the recent offerings have been priced at an average of 64 percent of book value, as opposed to the 73 percent in 1994, when the Feds were leaning on underwriters (who price the shares) to make the thrift conversions less lucrative.

It still makes sense to do what I suggested a year ago in these pages: Scout the area where you live or work for thrifts that haven't yet gone public, and open a savings account in each. In most cases, if you maintain an account for six months, you'll be able to buy shares if a conversion occurs. If the conversion never happens, you haven't lost anything, and you'll collect interest along the way.

The number of unconverted institutions has dropped from 2,524 ten years ago to 1,036 today, and at the rate they've been going public, they may all be public by 2005. Although many of the remaining thrifts are small (many have only one branch), my sources at SNL Securities estimate they represent between $1.5 billion and $2 billion in "embedded gains" that could end up in the pockets of the pioneer investors.

SNL's update on likely conversion candidates is shown at left. We offer our special thanks to Paul Doherty and Bill Kerkam for providing us with this data.

Before you purchase a single share in a thrift going public, you'll receive (as an account holder) a prospectus with all the details about what you may be buying__this is one gift horse whose mouth ought to be looked into. Here are some of the important points: * At minimum, you want the thrift to be profitable. You're getting it for nothing, but unless it's a profitable and healthy enterprise, it may be worth less than zero. * You want it to have a solid balance sheet and not be saddled with problem loans. You want the price-to-earnings ratio to be relatively low (last year I suggested p/e's of 10 or below), the equity-to-assets ratio to be relatively high (5 or above), and the percentage of nonperforming assets to be on the decline. * You want to see insiders buying the shares and paying the same price as you. Insider buying must be fully reported in the prospectus, so you can easily find out whether the managers and directors are risking their own money on the future success of the thrift. If they believe in the deal as much as you do, it's a good sign. * You also want the amount of money raised in the offering to roughly correspond to the book value of the company before the offering. If a local thrift with a book value of $10 a share plans to raise $100 a share in the IPO, the buyers will be paying $100 to get $110 in assets__hardly a bargain. But if that same thrift with a $10 book value plans to raise $10 a share in the IPO, the buyers will be paying $10 to get $20 in assets, the kind of favorable math that produces a nice pop. * If you don't like what you see in the prospectus, you don't have to participate in the offering. Nobody is forcing you to invest. A special note about so-called "mutual holding companies." A small number of thrifts have adopted this form of organization because it allows them to sell a minority interest in the business, with the insiders keeping permanent control and preventing a potential takeover. These deals are less attractive for investors. The real earnings power and real book value of the banks are understated, and the stocks don't have much lift.

In years past, even if you never bought shares in a single conversion, you could make a good living buying shares in recently converted, profitable S&Ls; that were selling at modest p/e ratios and below book value. But the pickings are much slimmer than they were a year ago. As you can see in the table below, [Tables and graphs are not included in the Worth OnLine archives.] the S&Ls; I've put on the current research list are quite expensive compared with those on my earlier research list. Of the thrifts on this list, I own Astoria Financial, Cameron Financial, Carver Federal Savings, GP Financial, and Quaker City.

In 1994, 13 of the 15 publicly traded thrifts on my list had p/e ratios of 10 or below, whereas 7 of the 15 on my new list have p/e ratios above 10. On the 1994 list, 14 of the 15 were trading below book value, but on this latest list, nine are trading above book. It's hard to find real bargains in today's higher-priced market.

Before the moratorium, the typical thrift stock would advance in three phases: the original pop, the gradual rise to book value, and a secondary pop when the thrift was acquired by a larger institution at a premium to its book value. In recent years, these secondary pops have been quite spectacular, taking the stock prices to new heights__150 to 170 percent of book value. The possibility of a takeover gives us another reason for investing in thrifts, although in the near future, we may not see as many takeovers as we've seen in the recent past.

While 1995 has been a banner year for bank mergers__a trend that is expected to continue__the number of thrifts acquired by banks has been declining. Of the active buyers from 1991 to 1994 (including AmSouth, < wam-co NASD:FITB>Fifth Third, Bank of Boston, First Fidelity, First Interstate, Fleet, PNC, and Shawmut), only First Union has continued to buy thrifts. Measured by assets sold, the takeover rate in the first half of 1995 is 60 percent behind the 1994 rate. The experts at SNL Securities tell us this is because thrifts are currently too expensive.

We've gone through a period of bankers' nirvana, several years of steady interest rates and a decent economy, and banks have used these good conditions to eliminate problem loans and strengthen their balance sheets. If these conditions continue, so much the better, but if they don't, sooner or later we may see a sell-off in the thrift-banking stocks, which would create new opportunities all over again. There are two additional factors, one short-term and one long-term, that make thrifts attractive. In the short term, regulators are nearing an agreement that would lower the premiums on deposit insurance. There is already a surplus in the Bank Insurance Fund, which covers savings banks. The Savings Association Insurance Fund, which covers S&Ls;, is undercapitalized, and the government is considering hitting SAIF-insured institutions with a one-time charge of $6 billion to bolster the reserves. Following that infusion of money, the premiums on S&L; deposit insurance would be reduced as well.

For thrifts covered by the BIF, the drop in premiums could increase earnings by 10 percent or more. Those covered by SAIF will have to pay their share of the $6 billion, which might cost them 85 cents on every $100 of deposits. This one-time hit would cause them to suffer an immediate drop in book value, but the lower insurance premiums would boost their earnings for years thereafter.

In the long run, what keeps me interested in the banking and thrift business is the likelihood of future takeovers and mergers. As the government relaxes the prohibitions against interstate banking, we're bound to see more consolidation. There are too many banks and too many chicken restaurants in this country already. I've said this before, but Great Britain has a population of 58 million and only seven different banks, while we've got almost five times the crowd and more than 20,000 banks__if you count the credit unions, thrifts, national banks, regional banks, and so on.

We don't need all these separate buildings, software systems, boardrooms, and highly paid administrators. Every time a thrift is taken over, the acquiring bank can cut costs upstairs and increase productivity downstairs. The acquiring bank can make better use of the thrift's deposits by lending them to a wider range of borrowers over a larger geographical area and by making numerous types of loans where they have a lot of experience and expertise. The entire industry will become more efficient__just like the phone companies, drug companies, and a whole gamut of other companies already have.

Written with John Rothchild. Peter Lynch is vice-chairman of Fidelity Management and Research and the coauthor, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon and Schuster.

1992 RESEARCH LIST UPDATED

Bell Bancorp (BELL) $16.94 $30.75 82% Charter FSB Bancorp1 15.18 33.57 121 Liberty Bancorp (LBCI) 15.75 26.25 67 Germantown Savings2 21.50 62.00 188 People's Savings Finan (PBNB) 13.25 19.50 47 Bankers Corp (BKCO) 9.47 17.38 83 NS Bancorp (NSBI) 22.13 33.00 49 UF Bancorp3 16.75 38.70 131 Ameriana Bancorp (ASBI) 12.33 16.25 32 Eagle Financial (EGFC) 13.12 22.00 68

Source: SNL Securities, L.P. Recommended prices as of 7/21/92. Recent prices as of 8/15/95. 1) Charter FSB Bancorp was acquired by Sovereign Bancorp 11/1/94. Recent price reflects the exchange of Charter's stock. 2) Germantown Savings Savings Bank was acquired by CoreStates Financial Corp for $62 cash per share on 12/2/94. 3) UF Bancorp was acquired by Citizens Bancshares Inc. 8/4/95. Recent price reflects the exchange of UF Bancorp's stock.

1994 RESEARCH LIST UPDATED

Astoria Financial (ASFC) $29.13 $37.25 28% Ameribanc Investors Group1 1.44 3.00 108 Bay View Capital (BVFS) 20.50 25.00 22 California Financial (CFHC) 15.75 16.50 5 CENFED Financial Corp (CENF) 17.50 20.13 15 Brooklyn Federal (BRKB)2 34.00 37.25 10 FFY < wam-co NASD:FFYF>Financial Corp (FFYF) 14.62 21.31 46 Fidelity New York, FSB 3 16.63 29.00 74 GP Financial (GNPT) 19.87 24.75 25 < wam-co NASD:LVSB>Lakeview Savings Bank (LVSB) 11.04 17.38 57 < wam-co NASD:MIFC>Mid-Iowa Financial (MIFC) 7.18 10.50 46 North Side Savings Bank (NSBK) 16.78 27.25 62 Pamrapo Bancorp Inc. (PBCI) 14.00 22.88 63 Queens County Bancorp (QCSB) 24.83 33.25 34 Sunrise Federal (SUNY) 21.00 30.13 43

Source: SNL Securities, L.P. Recommended prices as of 3/1/94. Recent prices as of 8/15/95. 1) Ameribanc Investors Group was bought out by First Union of Charlotte, NC for $3 per share in cash on 4/1/95. 2)Crossland Savings changed its name to Brooklyn Federal. 3)Fidelity New York was bought out by Astoria Financial for $29 per share in cash on 1/ 31/95.

SUCCESS STORIES OF 1994

IPO recent percent Thrift DATE Price price gain

(The five most successful initial public offerings of thrifts last year)

Harbor Federal Savings Bank (HARB) 1/6/94 $10 $23.00 130% Security Capital Corp (SECP) 1/3/94 25 52.63 111 First Kent Financial Corp (FKFC) 6/27/94 10 21.00 110 Bay Ridge Bancorp, Inc. (BRBC) 4/6/94 10 20.88 109 Financial Corporation (GTFN) 3/31/94 10 20.38 104

Source: SNL Securities, L.P., Charlottesville, VA. Recent price as of 8/ 1/95.

THRIFTS TO RESEARCH FOR 1995 Publicly traded savings banks and S&Ls; deserving of a closer look

THRIFT STATE Equity Price P/E Assets to Assets to Book ($ billions)

Albank Financial Corp (Nasdaq: ALBK) NY $28.75 11% 114% 12 $3.0 Astoria Financial (Nasdaq: ASFC) NY 37.25 9 96 8 6.4 Cameron Financial (Nasdaq: CMRN) MO 13.00 28 79 12 0.2 Carver Federal Savings (Nasdaq: CARV) NY 7.00 10 47 12 0.4 Charter One Financial (Nasdaq: COFI) OH 26.75 6 155 8 6.3 First Federal Financial Corp (NYSE: FED) CA 15.00 4 86 9 4.2 GP Financial (Nasdaq: GNPT)1 NY 25.25 11 128 9 14.4 Home Financial Corp (Nasdaq: HOFL) FL 15.00 26 115 15 1.2 ISB Financial (Nasdaq: ISBF) LA 15.00 21 90 13 0.6 Leader Financial (Nasdaq: LFCT) TN 32.75 8 154 9 2.7 Portsmouth Bank (Nasdaq: POBS) NH 12.25 25 107 11 0.3 Quaker City (Nasdaq: QCBC) CA 12.75 10 78 12 0.6 Queens County (Nasdaq: QCSB) NY 34.00 18 105 9 1.2 Standard Federal Bank (NYSE: SFB) MI 34.50 7 152 8 13.0 Washington Mutual (Nasdaq: WAMU) WA 23.25 6 141 9 20.3

Source: Prices as of 8/17/95. 1) All data incorporates the pending branch purchase from H.F. Ahmanson & Co.

KEYWORDS: Banking Industry, Stock Investing Strategies

96/01-Peter Lynch By Post

The stock picker's stock picker finally catches up with his mailand answers readers' questions

By Peter Lynch

Letters from readers have been piling up on my desk for morethan three years. I appreciate the fact that so many of you havetaken the time to ask questions and make comments. This keepsthe mail carriers in shape, and I never get lonely. I'm takingthis opportunity to answer a few of your questions in public.

What's your current opinion of Pier 1 Imports?

Carl J. Cooper, Rockwall, Texas

I bought Pier 1 (NYSE: PIR) for the Magellan Fund in the mid-1980s,but it was really my wife, Carolyn, who discovered it. She likedthe eclectic assortment of furniture, rugs, pottery, and glassware--allimported from exotic places like Mexico and the Far East, butwithout the exotic prices these items would have fetched at Bloomingdale's.

In 1991, I recommended Pier 1 again after the stock had fallento $7 a share. The economy was in a recession, money was tight,and buying a new couch wasn't high on most people's shoppinglists. Mom-and-pop furniture stores were going out of business,and big department stores were closing their home-furnishingdepartments. I figured as soon as the recession ended and peoplecould afford to redecorate, Pier 1 would capture a huge chunkof a market that had been abandoned by its former competitors.Also, at the $7 price it looked cheap.

Today, Pier 1 has 651 stores. The key element to the expansionplan is that 100 of its newest 150 outlets have opened in whatthe company calls "single-store markets"--places like Hattiesburg,Mississippi; Rapid City, South Dakota; and Twin Falls, Idaho.The company is expanding into smaller cities where it can attracta bigger percentage of the shoppers. These people no longer haveto drive 150 miles to buy a rattan room divider.

Pier 1 has continued to cut costs and reduce debt, and it'salso expanding abroad, with ten stores in the United Kingdomand outlets installed in several Sears stores in Mexico. TheMexican experiment has been a modest success, in spite of a severerecession there, and when Mexico recovers, results should improve.Although 1995 has been tough for U.S. retailers, Pier 1's domesticsales are up 11 percent. The company is likely to post recordearnings of 85 cents a share for 1995. Analysts expect it toearn $1 a share in 1996.

As I write this, the stock is selling for about $10. Obviously,it's not as cheap as it was in 1991, but it's still undervaluedat 10 times the 1996 estimated earnings, in a market where theaverage stock sells for 15 times earnings. Pier 1 is a maturecompany that is no longer growing at 20 percent a year, but itcan be a decent long-term performer. I still own the stock. Andevery August, my two older daughters, who are away at school,furnish their rooms in Pier 1.

I enjoyed your article "Charlie Silk's 150-Bagger" in the May1994 issue. I'm curious about what sources Charlie uses to findcash-rich companies with no debt and good earnings growth.

C.J. Biddle, La Jolla, California

That was the article in which I nominated Charlie as the world'sgreatest amateur investor. Figuring he ought to answer your question,I coaxed him into providing the following:

My search for undervalued Nasdaq stocks begins with Barron's,which I study every week, noting the stocks making new 12-monthlows that have fallen 50 percent or more from their 12-monthhighs. I take this list of the downtrodden and review their fundamentalsin either the Standard & Poor's monthly guide or Moody's OTCIndustrial Manual. I reject the companies that have a low cashposition or a declining sales trend. I'm also looking for companieswhose current assets are at least two times greater than alltheir debt.

Whenever a company passes these hurdles, I call the investor- relationsperson and request the latest annual report, 10-K, proxy statement,and product literature. I study these materials to get a feelfor the business, the products, and the competition. Weighingthese various factors, I choose an "entry point," a price atwhich I would begin to accumulate the stock.

The most important factor is the cash or cash equivalents onhand. My goal is to find situations where there's little or nodebt and the cash per share is nearly equal to or greater thanthe price of the stock. I've never seen a company with a lotof cash and not much debt go bankrupt.

A basic rule is to have the safest investment value with thesmallest downside risk. The next most important considerationis the probability of a turnaround. Was this price decline atemporary aberration that can be reversed, and is there a possiblere-acceleration of growth?

This approach works best at the year's end, due to tax-lossselling pressures or after a significant market decline. In afrothy market, there are very few opportunities.

Last March you wrote about Cedar Fair. Of all the hundreds ofstocks available, how do you focus on a few to study and research?

Raymond Capobianco, Foster, Rhode Island

There are attractive companies everywhere: cyclicals, fast growers,slow growers, some that pay a dividend, others that don't. Mytheory is to stay flexible. When people limit themselves to acertain kind of company, they also limit their opportunities.

I'm always on the lookout for companies that have no debt, lowprice-to- earnings ratios, good records, and prospects in businessesthat are easy to understand. These don't come along every day.Once I get to know a company, I look for the chance to buy moreshares when the price happens to drop for reasons that have nothingto do with the fundamentals.

I discovered Cedar Fair L.P. (NYSE: FUN)in the pile of prospectuseson my desk. It had just come public in 1987, but it had ownedand operated its amusement-park business for over 100 years.Here was a company that had a good growth rate and paid a dividendof 10 percent, which is rare for a solid growth company

Later, my family and I did the on-site research, riding theroller coasters at Cedar Fair's three amusement parks in Ohio,Minnesota, and Pennsylvania. Many of the 70 million people wholive within driving distance of these parks already knew thiscompany firsthand, so they were a step ahead of me. This is anotherexample of finding great investments close to home. None of thebig Wall Street firms bothered to follow Cedar Fair, but amateurinvestors had the perfect chance.

The story is simple to follow. The parks are only open a fewmonths a year, so you've got those off-season months to studythe quarterly and annual reports. If the stock price drops inthe idle months, you know it's not because the company has reportedbad results. There are no results to report.

This is where it can pay to wait for a buying opportunity. In1987, Cedar Fair had just come public at $10 when the marketwent over the ledge. Suddenly, you could buy FUN for $6, withan 18 percent yield. Because the market had crashed, people wereworried that the country was headed into a recession. But ifyou did your homework, you realized that Cedar Fair's businesswouldn't be affected for at least six months, because the parkshad just closed.

In 1990, when the recession jitters hit the market once again,you had another opportunity to buy Cedar Fair on a dip. If youkeep a list of stocks you'd like to own and watch them like avulture, eventually you will get the chance to swoop.

Cedar Fair had a great run from its $6 low in 1987 to its all-timehigh of $36 in 1993. It's been trading between $26 and $36 eversince. The company also keeps raising the dividend--this year,it's $2.30 a share.

In 1995, Cedar Fair acquired two adjoining parks outside Kansas City, Missouri. Every year, a fantastic new ride is added atone or more of the parks, the latest being the new $12 millionroller coaster in Ohio. Next year, Wild Thing will be installedin the Valleyfair park near Minneapolis. This roller coasterwill be more than 200 feet tall, with a weightless zone at thecrest of the second hill. I can't wait to do the research onit.

The only hitch is that Cedar Fair enjoys a favorable tax status,which is likely to run out in late 1997. But the market has alreadydiscounted that. Even if Cedar Fair paid a normal tax rate in1996, the stock is valued at 15 times 1996 estimated earnings,so it's cheaper than the average company in the S&P; 500. I ownthe stock.

-----In Beating the Street you gave Body Shop a great write-up. Thestock has dropped nearly 49 percent since I bought it. What areits prospects?

William A. Boudreau Nesconset, New York

Here is another example of why investors should focus on whetherthe story is still valid. A stock can fall in half, only to reboundso you end up making several times your money. I'm not sure BodyShop (LON: BOS; ADR: BDSPY) will have such a rebound, but ithas the potential.

The stock price tripled from a low of 125 pence (this is a Britishcompany) in 1990 to a high of 375 pence in 1992, and lately ithas fallen back below 140. The earnings declined in 1993, largelybecause of recessions in three of the Body Shop's most maturemarkets: the U.K., Australia, and Canada. In 1994, the earningsmade a nice recovery, but the company predicts that they willbe lower for the first half of 1995. Earnings would be higherexcept the company is spending a lot of money to introduce newproducts in the U.S. and to revamp its packaging. The Body Shopfaces stiff competition from The Limited's Bath & Body Worksin the U.S. But whether Body Shop succeeds in the U.S. may notbe that important. What's really important is what happens inthe 44 other countries where it has gained a foothold.

The company could concentrate on those 44 markets alone andenjoy excellent growth for the next decade. But it has plansto open Body Shops in China, Korea, and India. This is a fast-growingglobal operation that is opening 150 new stores a year. Coca-Cola is in almost 200 countries worldwide, and there's no reason BodyShop can't reach the same audience.

A company that can manage to grow at 20 percent a year willdouble its earnings every three and a half years. The earningsquadruple every 7 years, and increase eightfold every 14 years.That's how you make big money.

That's the upside. I wouldn't take a chance on Body Shop ifthe company were saddled with debt. Then I'd be facing bankruptcyrisk. But Body Shop is debt free. It is a profitable company,and the stock is very cheap. In my opinion, the risk/reward isfavorable. I own it, and I'm sticking with it.

In October you wrote about buying shares in savings & loans.But how are the stocks of S&Ls; allotted to depositors? Does thenumber of shares you're allowed to buy depend on how much moneyyou have on deposit? It hardly makes sense to keep thousandsof dollars on deposit for a handful of shares.

Murray Dornfeld, New York, New York

You usually have to keep at least $50 on deposit, and sometimesthe minimum can go as high as $500, but beyond that, the sizeof the deposit has no effect on the allotment of shares if theS&L; decides to go public. You generally can buy as many sharesas anyone else.

It doesn't matter how you've deposited the money, whether it'sin a checking account, a savings account, or a CD. What doesmatter is when you opened the account. Again, the rules vary,but people who get first dibs on the shares are usually thosewho've had an account with the S&L; at least a year before it announces the offering.

It's too bad 98 percent of people who have deposits in S&Ls; that go public pass up the chance to research and then considerbuying shares. They throw away the announcements and prospectuses they get in the mail. Don't dismiss these offers. Most of them have turned out to be great investments.

Written with John Rothchild. Peter Lynch is vice-chairman of Fidelity Management and Research and the coauthor, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon and Schuster.

96/02-Mind Your P's and E's

A quick lesson in wiggle reading: The use of standard price and earnings charts topot good buys (and bad) in growth stocks.

By Peter Lynch

On my watch at the helm of the Magellan Fund , I often consulted a chart book to check the bearings of companies in the portfolio.Many investors focus on recent price, but I like to refer to certain 10-year and 35-year charts of earnings and price to give me a clue as to a stock's future value. The charts I use arepublished by Securities Research Corporation. A subscriptionis expensive, but many libraries carry the latest copies, sothey're easy enough to find.

Perhaps you follow the progress of companies with the price-to- earningsratio, or p/e. A chart will tell you more: It tells the storyof the ongoing relationship between the P and the E. It's likea tacking duel in a sailing race. As the earnings line (the E)gains or loses ground, the price line (the P) zigs and zags aboveand below it. E is the reality of a company's performance, whileP is led around by Wall Street expectations. Each chart revealssomething important about the way investors perceive a company.

The chart of the Standard & Poor's 500 Index (shown on the nextpage), which tracks earnings and stock prices of 500 large companies lumped together, lifts the fog from the market at large. We seethe E tailing off in the recession of 1990 and 1991, while theP was on the rise. The P was ignoring the drop in the E becauseinvestors anticipated the economic recovery that began in early1992.

To catch up to the rising P, the E basically had to double from1991 to 1994, which it nearly didŠtaking Wall Street by surprise.In 1994 alone, the E was up 40 percent while the P went nowhere.Then in 1995, the E was up another 20 percent, for a combinedgain of 65 percent in two years. This phenomenal rise in earningsis why the P in stocks had such a run in 1995.

This sort of chart reading works best with growth companies,ten of which also appear on the next page. I've also thrown ina cyclical, General Motors, for variety's sake. You can tella growth company because the E keeps on a steady course, withearnings higher each year. Once you've identified a growth company from the E line, you follow the P line to get a read on whether the stock is expensive or cheap, relative to its earnings.

Overpriced growth stocks are doubly risky: If the earnings take a dive, the stock price heads for the bottom, and even if the earnings go up, the stock price may take a dive, or at best treadwater. When you way overpay for growth, the risk/reward ratiois highly unfavorable. The charts can help identify those situations.

Here are the charts of 11 companies (in no particular order) and the stories they tell:

Abbott Labs is a typical growth company, with the E on the riseand the P maneuvering around it. Every few years, as in 1987and 1991, investors get carried away with Abbott's prospectsand bid up the P, which puts a lot of distance between it andthe E. The best time to buy the stock is when the P comes backto the E, or drops below the E, as it did briefly in 1993. When the two lines converge, it means the company's growth rate is equal to its p/e ratioŠa good opportunity to invest in futuregrowth at a bargain price. Today, we see the P drifting awayfrom the E; Abbott is no longer the bargain it was two years ago, despite very good profits.

Walgreen is an excellent drug chain whose P rides above the E most of the time. This shows that investors are so confident of Walgreen's knack for making money, they're willing to pay a high price for future earnings growth.

The P drifted sideways in 1993 and '94. People who look onlyat stock prices might have thought something was wrong with thecompany. But the E kept rising, so people who paid attention to earnings knew the company was doing fine. The price simply got too high, as it does from time to time. It's moving in that direction again.

McDonald's is in the news; Warren Buffett is reportedly buyingshares. No doubt he's aware of the risk: The gap between McDonald'sP and its E hasn't been this wide since 1987, just before theOctober crash. Investors are counting on McDonald's to speedup its earnings by sending more and more Golden Arches abroad.If McDonald's doesn't accelerate the E, there's potential troubleahead for the P.

Johnson & Johnson was one of my recommendations at the Barron'sroundtable in January of 1994. I'd noticed the P had taken arare dip below the E, which, as usual, was on a profitable tack.You can see what's happened sinceŠthe P reversed field and hasshot from under $40 to over $90. Johnson & Johnson is still agreat growth company with strong future prospects (I own it),but a wide gap has opened up between the lines.

Wal-Mart investors have had an unshakable faith in the rapidadvance of the E, so until recently they paid a big premium forthe P. Hence, there's been a gap you could drive a fleet through.By 1992, the P had strayed further from the E than at any timein the company's history. For three years thereafter, the earningsrose by nearly 50 percent and the stock went nowhere. Imaginethe stock's fate if the earnings had dropped.

Recently, Wal-Mart's p/e gap has narrowed, making it less risky than it was in 1992. This hulking giant can't be expected tokeep up the fast growth it enjoyed in years past, but the stockis priced for slower growth. The current p/e ratio on expected1996 earnings is about equal to that of the average stock. IfWal-Mart's new supercenter stores are successful, it has a decentshot at a decade of respectable growth.

General Electric investors have always lacked faith in GE'sability to speed up the growth rate, so the P travels close tothe E and often drifts below it. This chart is telling us: "GE can't keep up with a Wal-Mart or a McDonald's." Nevertheless,GE makes steady progress, and the E has always been on the rise.Saddam Hussein gave us a buying opportunity a few years backwhen the P veered sharply south in the months before Desert Storm.

Emerson Electric, a leading producer of electric motors andother industrial products, has sailed through recessions withouta hitch: 38 consecutive years of rising E. You can see the pointwhere Wall Street finally recognized Emerson as a reliable fastgrowerŠin 1991, the P crossed above the E, and it's stayed there ever since.

As of this writing, Emerson sells for about $80 a share, but if the market had continued to perceive it as an unreliable slow grower, the stock might well be selling for $55 a share, a $25 difference on the same earnings. Instead of being an $18 billion company, Emerson would be a $12 billion company. That's how muchfaith in future growth can affect a shareholder's pocketbook.

Coca-Cola's chart from 1984 to 1989 looked like it belongedto General Electric, and from 1988 forward, it looked like Wal-Mart's.The flagship of the soft-drink business suddenly was put on thefast track, and Wall Street noticed. While the E accelerated,the P raced ahead of it, creating a dangerous gap. At the startof 1992, any chart reader could see the P was out of line andthe E needed time to catch up to it. The P went nowhere for twoand a half years, while the earnings continued apace. Lately,the P has jumped again, and the gap has widened. Investors arebetting once more that Coke will speed up the E.

Who knows how high the stock price will go? Maybe it will hit $100 or $120 a share and go from overpriced to grossly overpriced.Such an advance won't do long-term investors any good. Sooneror later, the P will come back to more sensible levels, becausewith Coke in more than 195 countries already, how can its E growthaccelerate fast enough to support the rising P?

Automatic Data Processing is an even more consistent growerthan CokeŠ34 years of double-digit earnings growth every quarter,and all it basically does is handle other companies' payrolls.You had a great chance to buy it in 1989 and again in 1990, whenthe P and the E converged, but since that time, optimistic investorshave bid up the P and widened the gap.

Philip Morris is another fast grower that Wall Street givesno respect. It's a chronically underpriced growth stock whoseP stays well below the E most of the time. Investors continuouslyworry that Philip Morris will lose billions in lawsuits broughtby smokers. Yet in spite of its underachieving P, the stock is up tenfold in ten years, thanks to the spectacular rise in theE. If Philip Morris maintains its earnings growth, investorswill make money no matter what Wall Street thinks. Without thethreat of lawsuits, the stock would be worth $120 on earningsstrength, as opposed to the $90 it fetches today.

Now, General Motors. Can you see why this chart doesn't fitwith the others? The E wobbles all over. It's the typical courseof a cyclical company, as unpredictable as a hurricane's path.From 1984 to 1989, GM's E was far above its P, yet the P neverrose to meet it because investors didn't believe the prosperitywould continue. They were right: From 1990 to 1992, the E felloff the chart. GM was losing billions. Today, the E has movedback to the top of the chart, but judging by the sluggish P,investors are doubting it will stay put. GM has cut costs and revamped its operations. There's a chance the E will continueto advance and GM will ride out the next recession in the black.If that happens, investors will probably value earnings morehighly in a subsequent recovery. It's a stock I own.

After saying so much about charts, I must issue the following disclaimer: I'm not a technical analyst, or a wiggle reader who makes predictions on the direction of the next wiggle. I usecharts to help me find value among growth companies I follow.

I'd be the last person to suggest using these charts to sell your growth companies every time they looked way overpriced.Instead of investing for the long term, you become a market timer.But if you've got an extra pile of money to invest, and you seethat your favorite growth company's P has far outdistanced itsE, you might want to hold off on buying the stock until it becomesmore reasonable. "Buy on strength," advisers may tell youŠbutthe charts show it's a lousy strategy.

Do-it-yourselfers can plot their own charts with the help of the National Association of Investors Corporation, an umbrella organization for more than 18,000 investment clubs. They evenhave the graph paper with properly aligned price and earningsscales. For details, call 810- 583-NAIC.

Peter Lynch writes Investor's Edge with John Rothchild, and is vice- chairman of Fidelity Management and Research. Their thirdbook, Learn to Earn, was recently published by Simon & Schuster.

96/04-The 5 Percent Solution

Thanks to a diligent reader, a crucial adjustment to the stay-in-stocks strategy

By Peter Lynch

Last September's cover story, "Fear of Crashing," drew more response than any other article I've written. The subject was how to weather a stock-market correction, which many pundits said was imminent as the Dow hit 4700. By mid-February of this year, the Dow had risen to 5600, so a 16 percent correction would have taken it back to the 4700 that people were worrying about when the piece was written.

This supports the main point I was trying to make: Corrections are unpredictable. By selling stocks to avoid pain, you can miss the next gain.

The most thoughtful and challenging response to "Fear of Crashing" came from Scott Burns, a columnist for The Dallas Morning News. Burns found a flaw in my argument that an investor who needs income can use a stock portfolio as a bond substitute, boosting the yield when necessary by selling shares out of the portfolio. His column ran under the headline "Peter Lynch's Stock Theory May Be a Bust."

Here's the plan as I presented it. Let's say you have $100,000 to invest and you want to produce a $7,000 income stream. That's 7 percent a year. The normal course of action would be to buy a 7 percent bond that matures at a much later date: 20 years or longer. But suppose you reject that option and put the $100,000 into a portfolio of dividend-paying stocks or into a growth-and-income mutual fund that owns dividend-paying stocks.

At the end of the first year, you get $3,000 worth ofdividends from your portfolio, leaving you $4,000 short onthe income stream. You make up the difference by dipping into capital and selling $4,000 worth of shares inthe stocks or the mutual fund you bought 12 months earlier.

In financial circles, dipping into capital is a no-no, but in this case, if you accept certain assumptions, it makes sense. You have to believe that stock prices will continue to rise over time and that companies will continue to raise dividends at the same rate. You have to believe that stocks will produce a total return of 10 to 11 percent a year, on average, as they have in the past.

You might be forced to dip into capital for several years to engineer the 7 percent return, but as the companies in your portfolio raise their dividends, eventually you'll get $7,000 without having to sell any shares. Twenty years later, if stocks behave as advertised, the portfolio will be worth $349,140, so you will have more than tripled your money on top of the annual $7,000 you extracted. If you bought a $100,000 bond, the most you could hope for is your to get $100,000 back.

In a bull market, this plan is a cinch to succeed--last year, for instance, when the total return from stocks was 37 percent, you could have withdrawn $7,000 and still come out $30,000 richer. My chief concern was how it would work in a bear market. I asked a number cruncher to crank up the computer, and we tested two nightmare scenarios. In the first, stock prices drop 25 percent the day after you invest the $100,000. In the second, stocks and dividends rise at half the normal rate for the next 20 years. As I reported in "Fear of Crashing," the computer's verdict was thumbs up. In the first hypothetical case, you could take home your annual $7,000, and two decades later you'd be looking at a portfolio worth

$185,350. In the second, you'd end up with $100,000, so you'd get back the same amount as you would have from a bond. This is where Scott Burns had his doubts.

With the help of a couple of brokerage houses, Burns tested the plan on the Standard & Poor's 500 and other stock indexes going back to the 1960s. Using data from real life, Burns found a worse worst-case scenario than my two imaginary ones: the Papa Bear market of the early 1970s. In that disaster, stock prices dropped a quick 40 percent and didn't regain their lost ground until the early 1980s. Any hapless investor who had bought at the top and followed the plan, withdrawing $7,000 a year, would have gone broke. By the time the next bull market rolled around, there would have been no money left in the account.

On the off chance that Burns's computers had caught a virus, I sought a second opinion on his second opinion of my first opinion. John McAllister, at the Boston-based Keystone group of mutual funds, agreed to run a test on Keystone's Growth and Income Fund, also known as S-1, which goes back to 1935 and has had a habit of paying a regular dividend. The results were disappointing. If you put $100,000 into S-1 at the peak of the market in January 1973, and extracted $7,000 every year thereafter, you were penniless by 1991.

Burns deserves kudos for bothering to figure this out. Clearly, it's not safe to withdraw $7,000 from a stock portfolio or a stock mutual fund if you had the bad luck to buy on the eve of a 40 percent correction leading to a 10-year bear market.

Now, I chose this 7 percent figure arbitrarily. If I'd given it more thought last fall, I would have remembered that hospitals, museums, universities, etc., customarily take a 5 percent annual draw, as they call it, from their endowments. The fiduciaries who manage those endowments are a cautious bunch. They must have chosen 5 percent for a reason.

With that in mind, I asked Keystone to test a 5 percent annual draw from the S-1 fund, assuming one had the misfortune of buying at prePapa Bear market prices in 1973. After five years, a $100,000 investment was reduced to $52,671, but eventually, stocks rallied enough to overcome this double whammy of declining prices and regular withdrawals. After 20 years, the portfolio was worth $107,653, so at least there was a $7,653 profit.

Granted, a 5 percent annual return on a $100,000 investment over 20 years, plus a $7,653 capital gain, is nothing to marvel at. But we're talking about the worst-case scenario since the crash of 1929. Stocks in 1973 had a long way to fall, because they were selling for ridiculous prices--for instance, 90 times earnings for Polaroid, 83 times earnings for McDonald's, and 76 times earnings for Disney.

Today, the Dow is selling at 16 times its 1996 earnings as projected by Wall Street analysts, which puts it in the middle of the range of 10 to 20 times earnings, where it has roamed for 50 years. If the Dow went to 15,000 next week and you put $100,000 in the market, I guarantee you'd be unhappy with the results of a 5 percent withdrawal plan--or a 0 percent withdrawal plan, for that matter. Then the market would be selling for 45 times earnings, and a nasty correction would be inevitable. Otherwise, you'd have stock prices going sideways for 12 to 15 years while the earnings caught up to them. As long as people are willing to pay foolish prices for things, no plan is foolproof.

That said, the 5 percent withdrawal plan seems to work well at least back to 1960; in the worst case you made a little money and in the best case you made a lot of money. If your timing was right and you bought S- 1 at the beginning of the bull market in 1982, then by the end of last year you would have had $360,314.

By the way, Burns wrote a sequel to his second opinion, in which he tested a 6 percent withdrawal rate on the Lipper Growth and Income Fund Index, going back to 1965. In the worst-case scenario involving that index, if you invested $100,000 and withdrew $6,000 a year, you ended up with $133,869, and in the best-case scenario, you amassed $914,682, which is a big improvement over the $100,000 return of principal from a bond.

THE BASICS HAVEN'T CHANGED

As long as I'm revisiting an old topic, I can't resist a chance to repeat some key points in brief, in case somebody out there missed the sermon. Here are some things to think about.

*If timing the market is such a great strategy, why haven't we seen the names of any market timers at the top of the Forbes list of richest Americans?

*People who exit the stock market to avoid a decline are odds-on favorites to miss the next rally. If you don't believe corporate profits will continue to rise, and you can't stomach a decline in the market, don't buy stocks or equity mutual funds.

*If you were out of stocks in 40 key months over the past 40 years, your annual return on investment dropped from 11.4 percent to 2.7 percent. You underperformed your savings account.

*In this century, we've had 53 corrections of 10 percent or more, roughly one every two years. We've had 15 corrections of 25 percent or more, roughly one every six years. These setbacks are normal and come with the territory.

*A stock certificate is not a lottery ticket. Behind every stock is a company. Stock prices go up 8 percent a year, on average, because corporate profits go up 8 percent a year. Add in the dividend yield of 2.5 percent (today's levels) and stocks give you a total return of 10.5 percent. Dividends are raised, on average, by 8 percent a year, right along with corporate profits.

*Even if we go into a long economic slump during which corporate profits grow at only half the normal rate, or 4 percent a year, stock prices should follow suit, rising an annual 4 percent a year. Assuming the 2.5 percent dividend, you would still get a 6.5 percent return, which is better than a 6 percent bond.

*Stocks outperformed bonds in eight out of the nine previous decades in this century, and they are well ahead halfway through this one.

*Since 1965, if you bought stocks once a year and were unlucky enough to pick the worst day to invest (when stocks were at their highest prices) 30 years in a row, you ended up with an annual return of 10.6 percent. If you were incredibly lucky and invested on the best day of the year 30 years in a row, you ended up with an annual return of 11.7 percent. So the difference between perfect timing and horrendous timing is 1.1 percent. This timing business is much ado about very little.

*In a correction or a bear market, great companies, good companies, mediocre companies, and terrible companies all see the prices of their stocks decline. A correction is a wonderful opportunity to buy your favorite companies at a bargain price.

Peter Lynch writes "Investor's Edge" with John Rothchild, and is vice- chairman of Fidelity Management and Research. Lynch and Rothchild's third investment book, "Learn to Earn," was recently published by Simon & Schuster. The opinions expressed in this column are strictly those of Peter Lynch, and do not reflect the opinions of Fidelity Investments.

96/06

In Defense of the Invisible Hand

Difficult as layoffs are, they happen for good reasons -- and produce results we wouldn't want to live without

By Peter Lynch

Has the invisible hand ever been so invisible as it is in our country today? I'm referring, of course, to Adam Smith's notion that the market forces of capitalism will produce the best results -- economically and socially -- if they are simply left alone. These days, everyone seems to have forgotten Adam Smith. The press is fixated on layoffs and business avarice.

"Call it 'in-your-face capitalism,'" Newsweek barked. "You lose your job, your ex-employer's stock price rises, the CEO gets a fat raise." The sentiment was echoed by Business Week. And TheNew York Times logged in with a seven-part series that focused on two groups of people: those who had gotten the ax and those who still had jobs but were worried the ax would fall on them next. The employed and the unemployed alike were depicted as victims of corporate greed. CG has become such a hot campaign issue that even the Republicans have been denouncing it.

It goes without saying (although I'll say it anyway) that there's nothing happy about somebody losing a job, especially if that somebody has no immediate prospects for finding another one. Only an ice sculpture would not feel compassion for the thousands of workers getting pink slips from AT&T;, or the three million who were let go by the 499 other Fortune 500 companies in the 1980s, or the next three million who will be idled by the end of the 1990s. That these widespread layoffs have created widespread financial and emotional hardship is beyond doubt. What I doubt is the conclusion that some people appear to be drawing from all this -- namely, that capitalism is evil and exists to spread misery by separating people from their livelihoods.

Job insecurity has been a problem for as long as people have depended on a paycheck. In the last century, half the U.S. population lived and worked on farms, so we've already lost two-thirds of the farming jobs. At one time, there were more than 200 manufacturers in the auto industry; at another point, the steel industry employed one of every 100 workers. Today, we have a handful of auto companies and two-thirds of the steel jobs have disappeared, but somehow the country has managed to survive and prosper.

Many companies can and should do more to help the recipients of pink slips get the training and referrals they need to catch on someplace else. But the pessimism aroused by layoffs per se simply isn't justified. We got a similar dose of pessimism in the late 1940s and into the 1950s, after the war was over and 10 million to 20 million Americans lost their war-related jobs in the defense industries. More than a third of the workforce had to find employment elsewhere. Life looked bleak for millions of workers.

Today, there's also an ominous sense that the recent pace of layoffs in the big-name companies will continue. More likely, we are closer to the end of the dismissals at places like AT&T.; These companies can't run on zero employees. Moreover, most of the reductions are not as heartless as they look, because they are accomplished through normal attrition: People retire, they change careers, they move elsewhere.

Again and again, new opportunities have arisen to take the place of the lost opportunities. This is the way the capitalist ecology works. Industries decline, old companies wither away, and young companies rise up to replace them. This process is hard on many, but ultimately, it is healthy.

The strength of our economy is that it is dynamic and always adapting to changing conditions. That's our advantage in the world. That's the reason we're as creative as we are as a nation. We're number one in music, television, and movies. We're the low-cost producers in forest products, paper, aluminum, and chemicals. We're tops in software, robotics, cellular phones, pharmaceuticals, electronics, telecommunications, and farm equipment. We excel at genetic engineering, microprocessing, and networking.

Helped partly by a falling dollar and also by a revived domestic business climate, our share of the export market is rising. We ship steel to Seoul, transistors to Tokyo, cars to Cologne, spandex to Siena, and bike parts to Bombay. Seven hundred million men and women worldwide shave with Gillette. The skies are filled with Boeing aircraft. Japan may have been the master of memory chips, TVs, and fax machines, but the Japanese can't keep up with the brainstorms coming out of U.S. companies like Intel, Texas Instruments, Cisco Systems, Sun Microsystems, Novell, Bay Networks, and Microsoft. We dominate every phase of computing, from software and hardware to printers and workstations.

The improvements in productivity achieved by business in this country have benefited nearly everyone in some way. Consider what's happened to the telephone industry. In 1983, AT&T; was a monopoly with a million employees. Today, among Ma Bell and the seven Baby Bells, there are 750,000 employees. These 750,000 are handling twice as many calls as their counterparts did in 1984 -- plus all the data, fax, and cellular exchanges that didn't exist in 1983. People are paying less for phone calls and getting more for their money.

It's amazing that the basic cause of the downsizing is so rarely acknowledged: These companies have more workers than they really need -- or can afford to pay. CEOs aren't callous Scrooges shouting "Bah humbug" as they shove loyal workers out the door; they are responding to a competitive situation that demands they become more productive. Would we be leading the world in so many industries if capital and labor were trapped together in outmoded, inefficient businesses with millions of workers holding down unnecessary jobs only for the paycheck? That was the situation that helped cause the collapse of the Soviet Union.

In spite of the continual process of certain industries' shedding their excess workers, America has been expanding the workforce at a record rate. According to the Bureau of Labor Statistics, we've added 54 million jobs in this country since 1965, so nearly half the jobs that exist today didn't exist 30 years ago. The nations of the European Union, with nearly a third more people than the U.S., have added a fifth as many jobs over that same period.

That means we're about 40 million jobs ahead of the Europeans, who for the longest time were held up as a model of efficiency and humanity in labor. Yet they've got 11 percent unemployment to our 5.6 percent, and nearly 20 million Europeans are now out of work. The United Kingdom's job rolls have barely grown (and by some accounts they've actually shrunk) since the Beatles cut their first album. What do these numbers tell us about the comparative strength of our economy versus theirs?

There's no doubt some people have been forced into lower-paying jobs, and one group is clearly worse off than it was in 1965: the people whose education stops at high school or below. That's because steel companies and other heavy industries are no longer hiring high-paid unskilled labor. Much of the assembly-line work has been automated.

But the myth that corporate chieftains squeeze labor to fatten their own paychecks is just that: a myth. When health-care and other benefits are added to the equation, U.S. workers are paid a bigger share of corporate revenues than they were in the 1950s and the 1960s, which are regarded nostalgically as the heyday of American labor. Meanwhile, corporate profits are actually lower now than they were then by a large margin: 10 percent of revenue in the 1950s; 5 percent today.

From time to time, you'll find a corporate type who tries to profit at the expense of the business; we saw that in some of the leveraged buyouts of the 1980s. But as a rule, the self-interest of the CEO and the interest of the company are identical. The executives, the shareholders, and the people on the assembly line are basically in the same boat. Ask yourself this: Where is it more rewarding to work, at a struggling Kmart or a thriving Microsoft?

If we must blame somebody for the layoffs, it ought to be you and me. All of us are looking for the best deals in clothing, computers, and telephone service -- and rewarding the high-quality, low-cost providers with our business. I haven't met one person who would agree to pay AT&T; twice the going rate for phone service if AT&T; would promise to stop laying people off. These companies are responding to the constant pressure from consumers and shareholders.

By the way, the competitive pressures that companies face don't necessarily come from abroad. AT&T; isn't worried about losing customers to Telfonos de Mexico or Philippine Long Distance. It's worried about losing customers to MCI, the cable systems, the Baby Bells, and a slew of small companies (called resellers) that offer discount phone service.

Let's look at the market forces in action. Older companies in established industries are struggling to keep up with the times. Younger, more aggressive companies are challenging the older companies or starting new industries from scratch. The jobs lost when the older companies falter are made up and then some in the younger companies that succeed.

Business today is criticized for being heartless and greedy, but it was lambasted for being soft, lazy, and out of touch with reality not long ago. In the mid-1980s, we learned that the Japanese made better products than we did, and that the Germans worked harder than we did, and that while our corporate leaders were thinking about their golf scores and getting a good table at Lutce their corporate leaders were plotting how to outsell and outproduce us.

Detroit was the target of much of the criticism, and it deserved what it got. The Big Three auto companies made second-rate cars in run-down factories as the unions pressured them to pay higher and higher wages, which were tacked onto the price of the cars. So consumers got less car for more money, until the Japanese and the Germans arrived and offered more car for less money. Millions of once loyal domestic car buyers defected to foreign brands, and the auto industry became a symbol of the decline and fall of U.S. industry in general. From 1979 to 1982, Chrysler was in a more or less constant state of crisis, with bankruptcy a serious threat. Chrysler was saved by strong leadership, layoffs, cost cutting, and an impressive lineup of new products (the minivan, the K-car, the revamped Jeep, etc.). It did get $1.5 billion in federally guaranteed loans in 1980 (which made it possible for the company to actually produce the cars that would save it), but it paid off every dime. The strong leader was Lee Iacocca, and the turnaround he orchestrated was so successful that he deserved every penny of whatever Chrysler paid him.

Without Iacocca, it's quite likely that Chrysler would be as extinct as Studebaker or Nash. But it is alive and solvent enough to support perhaps 500,000 workers, if you count its 126,000 employees plus those of its suppliers. That's a huge number when you consider there are only 18 million manufacturing jobs left in the U.S. Last year, Chrysler employees got an average of $3,200 in profit-sharing bonuses.

Other manufacturing companies followed Chrysler's lead in downsizing, cutting costs, and developing new products. Few were in as desperate a fix as Chrysler, but they had all struggled through the recession of 1982. They decided to make big changes that would free them from the old routine of adding workers in good times and laying them off in bad.

The urge to become more productive with a smaller workforce spread from manufacturing into retailing, pharmaceuticals, banks, financial services, and, most recently, newspapers and entertainment. Even when companies posted record earnings, they put themselves through the Chrysler drill (cut costs, make better products) to prepare for tougher times ahead. They wanted to avoid the fate of some very large companies that had failed to prepare and were lost in Chapter 11.

As a result of this efficiency campaign, the U.S. labor force has become the most productive in the world. According to the most recent numbers from the Bureau of Labor Statistics, the average American worker produces $49,600 worth of goods per year, $5,500 more than the average German and almost $12,000 more than the average Japanese. This extra productivity gives a company a lot of options.

Let's say it builds a new plant, where the same work crew from the old plant can increase the output by 15 percent. It can use that 15 percent to give employees a 5 percent raise, making the workers happy; to lower prices by 5 percent, making customers happy; and to still increase profits, making the shareholders happy. Of course, the productivity windfall could be divided up in different ways, but the point is that there are multiple benefits to becoming more competitive.

If you ask me, we have two key factors to thank for whatever prosperity we have enjoyed as a nation in recent years: Enough large companies have continued to do well, la Chrysler, while small companies have blossomed. Without one or the other, we'd be in a sorry state.

A list of 25 large companies that have managed to stay in top shape appears on page 90. Many names could have been included, but these are some of the standouts. A few have overcome serious trouble. Others are in the process of turning themselves around. Others have kept up their earnings growth against the odds. Others have accelerated their growth rates, which is a rare feat for a giant enterprise such as Coca-Cola.

Hewlett-Packard is one of the companies that hit the accelerator. In 1975, it was a manufacturer of testing and measuring equipment, one-fifteenth the size of IBM, with annual sales of $981 million. In 1995, its sales were $31.5 billion, only 10 percent of which came from the testing and measuring divisions. The vast majority of sales ($25.3 billion) came from printers and computers. Hewlett-Packard is now half the size of IBM, a leader in printers, and ranked sixth in computer sales worldwide, even though as late as 1983 it had never made a printer. It was reinvigorated by employees who were encouraged to dream up new products.

Lumped together, the 25 companies on the list have doubled their sales and profits in the recent decade. They've also cut 363,000 jobs, making them likely targets for negative publicity about the downsizing disease, but I cringe when I try to imagine the troubles we'd have if they hadn't downsized and created better products. A few big bankruptcies in the Fortune 500 are all it would take to stretch the unemployment lines around several blocks. Instead of 3 million jobs lost in the 500 largest companies, we might have lost 10 million or 15 million.

While the innovative large companies have been holding up their end, the small companies have been blossoming remarkably. No one has an exact count on how many jobs they've generated, but we do know that 6.3 million new businesses opened their doors in the U.S. in the 1980s alone.

Among these 6.3 million new businesses is an elite group of high achievers. Twenty-five of the most successful are listed on page 92. All but one (Cabot) went public in the past two decades. Had we packed the list with the all-stars of the computer industry, the performance of the group would have looked even better. But we chose a representative sample from different industries to show that companies of all kinds can grow up very fast in America. We included a toy company, a payroll processor, an airline, even a company that makes the carbon black used to strengthen tires. That's Cabot, which went through a difficult period but turned itself around.

In 1985, these 25 small companies had sales of $31.4 billion combined, less than half the sales of Exxon alone. Their combined earnings were one-quarter of IBM's earnings. They employed 368,000 workers, while the 25 firms in our large-company category employed 2.6 million workers.

By March 1996, the small companies had sales of $260 billion and employed more than 1.4 million workers. So while our 25 large companies were cutting 363,000 jobs, the smaller group was adding more than a million.

Wal-Mart was small enough to make the small-company list in 1985, but today it is bigger than every company on the large list except Exxon. Toys 'R' Us was a medium-sized company in 1985, but now it has more sales than Gillette or Colgate and 22,000 more employees than Goodyear. Amgen didn't exist in 1975, and in 1985 it employed 200 people. Today, it makes a pair of $200 million pharmaceuticals, Neupogen and Epogen, which helped Amgen earn more than $538 million in 1995.

Behind each of these companies is a leader or a couple of leaders who had the vision and the gumption to do something different. Thomas Stemberg took the business plan he wrote after getting fired from his job with a grocery chain and turned it into Staples, which has 25,000 employees. The $3 billion company he has created will be a $10 billion company by the year 2000. Herb Kelleher turned a hub airline into the powerful Southwest Airlines, which employs almost 20,000.

Some people think Federal Express followed the pony express, but in 1973 it was an idea rattling around in the head of Frederick W. Smith. Smith revolutionized the delivery business. When Bill McGowan and Bert Roberts at MCI dared to compete with AT&T; in the long-distance market, people laughed at them. For ten years, MCI lost money, but it has survived and succeeded. Because of MCI's competition, we all pay less for long distance.

Twenty years ago, Nucor was a small steel manufacturer whose embrace of a new technology called thin-slab casting allowed it to thrive when other steel companies were stumbling. Chairman Ken Iverson pays his workers based on the company's performance, and today Nucor is the country's fourth-largest producer of steel. By 2000, it will outproduce USX, which back when it was U.S. Steel was the first billion-dollar company in U.S. history.

Without small companies flourishing underneath the big companies, the U.S. could easily have 15 percent unemployment instead of the recently reported 5.6 percent. Then we'd be in worse shape than the countries of the EU, where large companies have resisted laying people off and where 19.6 million people (10.9 percent of the workforce) are out of work. By being paternalistic and refusing to cut costs and innovate, Europe's big companies have stagnated. Small companies are simply hard to find. The 2,740 small companies that have gone public in the U.S. in the 1990s are probably more than Europe has created in the nine centuries since Charlemagne.

My guess is we're in the seventh or eighth inning of downsizing, while Europe has just entered the second or third inning. They've begun the painful process that we are close to completing, and they're doing it with 20 million people already out of work. They'll need a stronger drug than Prozac to help them cope with the problems that lie ahead.

Of course, we don't lack for problems, either. Our overall economic growth has lagged the growth rates of other periods in our history, and our lowest-paid workers are bringing home a smaller paycheck (adjusted for inflation) than they did 25 years ago. We've got high crime and high unemployment in the inner cities, where half the children never finish high school. Our dropout problem deserves the kind of attention the layoffs have been getting, and business is not doing enough to help with a solution. There are next to no dropouts in Taiwan and Korea, and those countries will have a big advantage over the U.S. in the next century because of it.

But when it comes to job growth, ours is the most dynamic economy in the world. I think much of the pessimism about the 1990s may turn out to be misplaced.

Peter Lynch has written three books with John Rothchild; parts of this article are adapted from the most recent, Learn to Earn, published by Simon & Schuster. The opinions expressed in this article are strictly those of Peter Lynch and do not reflect the opinions of Fidelity Investments.

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96/10

Self-Service

By Peter Lynch

Gas prices are headed just one way. Get the difference back, and more, with oil company stocks.

In this space back in February 1995, I made a case for the possible revival of the oil-service companies—the drillers and rig operators that Wall Street had left in a scrap heap. It turned out that the survivors shook off the rust and ironed out the balance sheets—which was a pleasant surprise to investors in Schlumberger , Halliburton, Western Atlas , and some others. The analysts I talked to at the time were optimistic about energy services, and it looks like they had the right idea. Schlumberger has gained 62 percent in about 20 months. Western Atlas is up 40 percent. Shares of Global Marine have risen almost fourfold, to $15 from $4.

Now is a good time to deliver what I promised in that earlier column: a follow-up on the rest of the oil-and-gas industry, namely the refiners, the pure producers, and the integrateds, which find, pump, refine, and sell oil and often do more besides. These three groups—which account for 90 percent of the oil business worldwide—include thousands of tiny companies with oily holes in the ground, plus the big names at the gas pump: Exxon, Mobil, Chevron, British Petroleum , Texaco, and Royal Dutch/Shell.

Oil is a timely subject on several counts, beginning with the current 3.8 percent dividend yield on the major oil stocks, which is nearly double the yield on the Standard & Poor's 500 Stock Index. (Dividend yield increases, of course, when a company raises its dividend more rapidly than the market bids up the stock price.) The relatively high yield in the sector is evidence that oil companies did not keep pace with the market in the past decade. This is the widest spread between oil yields and the S&P; yield in 45 years, suggesting either that oil companies are in lousy shape (which they aren't) or that Wall Street is giving them less credit than they deserve.

I'm reminded of the Baby Bells, which also lagged the market in the early 1990s and then had a nice rally. The parallels between the six Bells and the Six Sisters (the big names at the gas pump mentioned above) are intriguing. Both were created in antitrust breakups: AT&T; in 1984 and Standard Oil Trust in 1911. Both are widely held by individual investors and narrowly held by the pros at the institutions. In fact, only two of the Six Sisters appear in the top 20 holdings of equity mutual funds, according to the research firm CDA/Spectrum.

For this to become another example where the public is right, crude prices will have to rise from here. Just as there's no sense owning Kellogg's if you're bearish on cornflakes, there's no sense owning oil companies unless you're convinced that oil has a profitable future. On that subject, I'm not about to make any brash predictions, but I've begun to notice signs that the trend may be up—not for next month or next year, necessarily, but sometime before the Icelandic beach-volleyball team wins the gold medal.

On the demand side, you've got the commuters of the emerging nations driving more cars more often and developing an American appetite for high octane. Meanwhile, U.S. residents are holding up our end as the undefeated champs of gas guzzling. It seems like the 1970s all over again, with off-road vehicles as big as tanks and oxymoronic minivans filling the lanes where tiny Volkswagen Beetles once crawled.

The national speed limit was raised to 65 with hardly a peep from the energy-conservation faction, and this, along with the bigger cars and the widespread boredom with switching off the lights in empty rooms, will surely result in more barrels burned.

The daily world demand for oil now exceeds 70 million barrels, more than double the 31 million barrels a day we turned into heat, speed, and exhaust 30 years ago. More promising than that for oil investors, the annual rate of increase in demand has accelerated from 1.5 percent over the past decade to a projected 2.5 percent for the next two years.

There's no doubt the latest high-tech methods of drilling and exploring will capture oil in areas that were thought to be tapped out—it's already happening in parts of the North Sea and the Gulf of Mexico. But so far, the fancy probes with longer straws haven't produced enough oil to reverse an obvious and long-term decline: U.S. oil production peaked during the Nixon administration at ten million barrels a day. Today it's 6.5 million.

The price of oil went through the roof in the early 1970s, after the Arabs declared an embargo and stopped pumping. Adjusted for inflation, the price has gone nowhere since that expensive trauma. Because oil has been cheap all these years, people have begun to think we'll have cheap oil forever, the same way they thought the price would go up forever when it rose to $40 a barrel during the embargo. As it turned out, their predictions of $100 a barrel were completely off base, because the $40 price stimulated so much production among suppliers and conservation among consumers that it's taken a quarter century for demand to catch up to supply.

Because the cycles are very long, it's easy to forget that oil and natural gas are cyclical commodities that move with the vagaries of supply and demand. Today, we've got tight supplies and low reserves in both oil and natural gas, while demand continues to grow.

Stock pickers have Saddam Hussein to thank for the bargains that can be found in the oil sector on Wall Street. The threat of Iraq's opening the valve on its big pipeline has been weighing on these shares since the Gulf War. For four years, investors have worried that the world will be glutted with oil and the price will collapse as soon as Saddam resumes pumping. But if Saddam had continued to pump at the prewar rate of 3.5 million barrels a day, they wouldn't be worried. Meanwhile, worldwide consumption has grown by two million to three million barrels a day since the war, so the increased demand has already sopped up Iraq's potential supply.

If you expect oil or gas prices to go higher and you want to take advantage of it in the stock market, there are two ways to proceed. You can invest in the giant integrated companies, such as the Six Sisters, or you can sink your assets into the smaller, so-called pure producers, of which nearly 300 are publicly traded. Both strategies have potential merit. Investing in the integrateds is likely to be a safer bet with a more modest potential payoff. The pure producers are riskier, by and large, but they offer a more spectacular payoff if you invest in the right one.

The integrated companies are multinationals that work both ends of the pipeline, from the "upstream" wells and deposits through the refineries and neighborhood filling stations "downstream." And many of them have large petrochemical operations that at times produce substantial profits. Of the top 15 oil companies in the world, Exxon is the largest that's publicly traded.

The Six Sisters have reduced debt in recent years, and their dividend payout is a comfortable percentage of their cash flow. Their aggressive cost cutting enables them to make a profit on a lower price of oil. However, the strength of the Exxons and the Mobils is also their weakness. While their size and their clout protect them in hard times, they also hold these companies back when conditions are favorable. Mobil is a perfect example. Since it refines almost three times as much oil as it produces, Mobil is a buyer of oil as well as a seller, so a higher oil price doesn't automatically translate into higher earnings. What it gains selling oil downstream, it may lose buying oil upstream.

A more serious drag on Mobil's potential gain from higher oil prices is that it is also a chemical company. This helps when the chemical business is good, but lately it's been sluggish. Otherwise, Mobil and the other integrateds might be doing better in the stock market, given the sharp rise in the price of oil.

You won't find either the pluses or the minuses of diversity with the pure producers. These companies work the upstream side of the pipeline, finding oil and then selling it. They run the gamut from low-budget operations with six employees, such as Bellwether Exploration, to midsize companies, such as Apache and Burlington Resources, which have around 2,000 employees each—still quite small when compared with Exxon's 90,000.

Unlike the integrateds, pure producers can't be counted on to pay a steady dividend or even to stay in business if oil prices fall below the point where they can afford to pump it. But if oil prices take a jump, these stocks will tend to follow the same trajectory.

I contacted several top analysts who cover the integrateds and the pure producers. Here are a few of their candidates for investment, starting with the small companies.

Mike Barbis at UBS touts Noble Affiliates (NYSE: NBL), based in Ardmore, Oklahoma. What he finds most attractive about Noble is that it owns more natural gas than oil; Barbis is more optimistic about natural-gas prices than oil prices. Noble earned 35 cents a share in 1995, and Barbis expects it to earn $1.50 this year and $2.05 in 1997. He also likes Louisiana Land and Exploration (NYSE: LLX), which has cut its production costs for oil from $9.27 a barrel to $7.20. Jim Clark at CS First Boston likes a Texas refiner called Valero Energy (NYSE:VLO).

Many pure producers are found in Canada. Martin Molyneaux at FirstEnergy in Alberta likes Canadian Occidental Petroleum (AMEX:CXY), a subsidiary of U.S.–based Occidental Petroleum. Among smaller companies, he likes Alberta Energy (NYSE:AOG) and Renaissance Energy (Toronto:RES).

Of the big companies, Michael Mayer from Schroder Wertheim likes Mobil (NYSE:MOB) and Texaco (NYSE:TX), to which he has assigned target share prices of $127 and $94, respectively—bumps of 14 percent and 9 percent from where the stocks are trading as I write. Jim Clark likes Unocal (NYSE: UCL)at its current price of around $34 a share. He's also recommending Texaco and Chevron (NYSE: CHV). He sees a jump in Texaco's earnings from $3.90 a share in 1995 to $5.55 in 1996 and $6.10 in 1997. Other analysts are projecting similar jumps for many companies in the oil group.

Remember my mention of the underweighting of these stocks among institutions? If good earnings reports convince institutional buyers that they've been wrong about oil, they'll rush in to buy. That will be nice for the individual investors who get there before the big players do.

And there's one more potential attraction to the integrateds: They may add ballast to a portfolio, because oil companies often thrive on bad news, such as wars. The oil embargo of the 1970s was a shock that seemed to come out of nowhere. Who knows where the next disruption could arise: a revolution in Saudi Arabia, a shutdown of the Soviet oil fields, an uprising in Venezuela? An oil crisis could even result when Japan or Germany emerges from its economic woes. It would take a shortage of no more than a million barrels a day to produce another shock in which oil and gas stocks would likely go up while most stocks were going down.

Peter Lynch writes "Investor's Edge" with John Rothchild and is vice- chairman of Fidelity Management and Research. Their third book, Learn to Earn, was recently published by Simon & Schuster.

97/01

Pain and Gain

By Peter Lynch

Letters have been piling up on my desk since December 1995, the last time I devoted a column to readers. Again, I want to thank everyone who took the time to write. The volume of correspondence makes it impossible for me to respond personally to all your questions and comments, but I have chosen a few to answer here.

On your recommendation, I purchased Au Bon Pain for $26.25 a share in January 1994. As of October 1996, the stock has fallen to six dollars. Is it worth holding, or should I sell and take the loss? Robert Schnell, Goshen, Indiana

Au Bon Pain has been a pain in the wallet -- although, if it's any comfort, I've made several recommendations over the years that were worse. The stock in this bakery-style café chain got off to a good start: from $9 a share at the initial public offering in mid-1991 to over $26 a year and a half later. Now it sells below the IPO price. Since I bought some for $22.75, you and I made the same mistake. Both of us should have paid more attention to earnings, which at one point were estimated at 80 cents a share for 1994. This gave the company a price- to-earnings ratio of almost 30, which readers of this column will recognize as on the high side.

If a company manages to increase earnings at 25 to 30 percent a year, then a p/e of 30 isn't too much to pay. But here's the catch: Au Bon Pain's earnings came in at 67 cents in 1994, then disappeared into a loss of 14 cents a share in 1995. Two things went wrong: Starbucks showed up as competition, along with all its clones and a zillion bagel shops, and at the end of 1993, Au Bon Pain acquired St. Louis Bread, a chain of bakery/restaurants where the costs rose faster than the loaves.

Whenever a company does as poorly as this one has, and you own it, the first thing you want to check is its finances. Can it survive the bankers and creditors long enough to turn itself around? On that score, Au Bon Pain gets a B minus -- not great, but okay. It has borrowed $75 million, but the balance sheet shows about $94 million in equity. More equity than debt is comforting. So is the eight-dollar-a-share book value.

Next, you check what the company is doing to solve its problems. Au Bon Pain has been successful in downtown areas but not in suburbs, so management is concentrating on the former. Of the 281 outlets, less than 5 percent have been duds, and these are closing. The others have worked out. Whenever I go into one, it's crowded.

St. Louis Bread has been the real source of trouble because the chain grew too fast and expenses got out of control. But people seem to like these family-style restaurants, which feature fresh-baked breads. The same-store sales are growing at double-digit rates. This year, an experienced restaurant team was brought in. A new bread factory (where raw dough is made) should be up and running by the time this article hits the stands. Getting the factory on line is costly in the short term, but once the bugs are worked out, the factory has the potential to reduce costs substantially and add to earnings.

Finally, you want to ask: What's the upside here if all goes well? Au Bon Pain is adding new outlets abroad, but St. Louis Bread is the key to the company's future. If that franchise can expand from 33 restaurants to 250 or even 500, it's not hard to imagine Au Bon Pain as a very big winner. To buy this stock now, or to hold on to it, you have to believe in St. Louis Bread.

Put me in the believer camp. I still really like the dedication and skill of top management. I bought more shares in August, September, and October.

I must take exception with a few of your comments with respect to market timing. Market timing, as it is practiced by the majority of investment advisers, is a risk-management approach to investing. It enables risk- averse investors to participate in the superior returns of the stock market at a reduced risk level. Jerry C. Wagner, Aurora, Colorado Society of Asset Allocators & Fund Timers

The only problem with market timing is getting the timing right. I haven't met many people who've done it successfully. Maybe once in a row, but not consistently. There's no telling how many timers miss big gains in stocks by making ill-timed exits. Look at the number of hedge- fund managers who've left the business since 1990.

If you had missed the 40 biggest up months on the Standard & Poor's 500 Stock Index in the past 40 years, your return from stocks would have dropped from 11.4 percent to 2.7 percent. That's how important it is to be invested in those key moments: 40 months on the sidelines out of 10,000 days of trading and you'd have been better off keeping your money in a savings account.

I've gone through this before, but let me give you another example based on actual stock-market performance from 1965 through 1995, a period with good years and bad. Imagine three investors, each of whom puts $1,000 into stocks annually over these three decades. Investor 1, who is very unlucky, somehow manages to buy stocks on the most expensive day of each year. Investor 2, who is very lucky, buys stocks on the cheapest day of each year. Investor 3 has a system: She always buys her stocks on January 1, no matter what.

You'd think that Investor 2, having an uncanny knack for timing the market, would end up much richer than Investor 1, the unluckiest person on Wall Street, and would also outperform Investor 3. But over 30 years, the returns are surprisingly similar. Investor 1 makes 10.6 percent annually; Investor 2, 11.7 percent; and Investor 3, 11 percent. Even I am amazed that perfect timing year after year is worth only 1.1 percent more than horrible timing year after year.

The only thing that might convert me into a one-shot market timer is if the Dow suddenly rose from 6,000 to 18,000 and the market was selling for 45 to 50 times earnings, so far beyond the pale of valuation that a huge correction would be inevitable. In such an extreme case, I might wait it out in Treasury bills. But as long as stocks continue to sell in the normal range of 10 to 20 times earnings, I'm staying in.

Ask yourself this: If stock prices dropped 10 to 25 percent, would you add to your positions in stocks and mutual funds, or would you cash out and cut your losses? If the answer is that you'd cash out, then do it now and avoid the misery that is sure to come later. Stocks are a safe bet, but only if you stay invested long enough to ride out the corrections. Remember what makes them a safe bet: corporate earnings. If earnings on the S&P; 500 quadruple over the next two decades, as they have in the past two, stock prices should rise at a corresponding rate.

How do you feel about bonds? Is it okay to stay with them? Worth OnLine Reader

After having written three books and numerous articles, I'm sure my feelings about bonds are hardly a secret. All things considered, I prefer stocks. People worry about the riskiness of stocks, but bonds can be just as risky. Look at what happens to the price of a bond fund the next time interest rates go up 2 percent.

If you could make the right call on interest rates five times in a row, you could buy $10,000 worth of bond futures, roll over the profits, and become a billionaire in short order. But the ranks of interest-rate billionaires are as thin as the ranks of billionaire market timers, which tells you that interest rates are tricky to predict.

If you stick with T-bills or money-market funds, you think your money is secure, but once you pay taxes on the interest, your return might not be enough to keep up with inflation. That's how people lose money on a "safe" investment. If you buy bonds with longer maturities, you get a better interest rate, but it's fixed. This exposes you to the risk of rising rates and falling bond prices. In that situation, you can either sell the bond at a loss or wait until it matures to get back the full amount of your principal. That's why, if I bought bonds, I'd go for the intermediate maturities -- three to five years. Who wants to be stuck with a 20-year bond in a period of rising rates?

Over the past six decades, with inflation running hot and cold, long- term government bonds have earned 1.9 percent over the inflation rate, versus 7.5 percent for stocks, according to Ibbotson Associates. What is this 5.6 percent difference worth? With $10,000 invested over 25 years, the difference becomes $38,000.

Only once in this century have bonds had a clear advantage over stocks: during the depression of the 1930s. If you're expecting another depression, then buy Treasurys.

That said, I'm going to keep an eye on the new inflation-adjusted bonds the Treasury Department will issue in January. The return on these bonds will be pegged to the consumer price index, so if inflation heats up, bondholders will be protected. Of course, if inflation cools off, these bonds may lose their advantage, but they have the potential to be better than money-market funds.

How do you see Wal-Mart? Worth OnLine Reader

This is the colossus of retail, with $93.6 billion in sales in 1995, more than Kmart, J. C. Penney, and Sears put together. In an average week, 60 million customers visit Wal-Mart stores; Wal-Mart takes in an annual $360 for every man, woman, and child in America. But after 35 years of rapid growth, 27 of them as a public company, how can this hulk maintain the pace? Lately, we've seen a letup in the earnings momentum: $1.02 a share in 1994, $1.17 in 1995, $1.19 in 1996.

The stock price has dropped from an all-time high of $34.125 a share to the mid-$20s, reflecting the slowdown in earnings and Wall Street's falling out of love with the company. Mark Husson at J. P. Morgan explains the problem of rekindling the relationship:

"I think that the growth guys look at it now and say, 'This isn't the old growth story we used to know. It's got a high-teen growth rate, below the 20 percent we once got from this company.' So the growth guys are not really interested anymore.

"If you're a value guy, you say, 'Wal-Mart is trading at a premium to its growth rate.' So the value guys aren't interested either.

"The momentum guy says, 'The chart looks awful. I'm not going to touch this.'"

Husson thinks of Wal-Mart as a proxy for retail in general, so if we have a good Christmas season in 1996, the stock might benefit. Beyond that, the company's fate is tied to the new Wal-Mart supercenters, which sell everything from appliances to groceries.

The first supercenters were rolled out in the heartland, where Wal-Mart began, but now they're moving into more densely populated areas, where the competition is tougher. The company opened 100 of these mega-sites in 1996 and plans to open another hundred or so in 1997, for a grand total of 420. It remains to be seen whether consumers will buy TVs, socket wrenches, and chicken soup under the same roof and whether Wal- Mart will get enough return on this investment to boost its profits overall.

Based on analysts' estimates for 1997, Wal-Mart will earn $1.36 a share, giving it a p/e of 20 at the current stock price of about $27. The company isn't the fast grower it was, but neither does it carry a fast grower's lofty price tag. If Wal-Mart can regain some of its earnings momentum, shareholders who buy at these levels can expect to be rewarded.

Do you prefer to look at a stock as a growth investment or as a source of income? Worth OnLine Reader

That depends on the stock. A stock that pays no dividend is obviously not an income investment. But in general, dividends are a more important part of the total return from stocks than people might think. According to Ibbotson Associates, the S&P; 500 returned 10.6 percent annually from January 1926 to September 1996, but only if you reinvested the dividends. Remove the dividends, and these companies returned only 5.8 percent.

Today, dividends are much lower across the board than they were a few years back: 2 percent on the stocks in the S&P; 500, versus 4 to 6 percent in the early 1980s. That's one reason some people are saying stocks are overpriced.

Fast-growing young companies, such as technology firms, don't generally pay dividends, which for them is a plus: They can invest in their own expansion instead of handing the money to shareholders. With slow- growing companies, a dividend becomes part of the attraction. Companies that continually raise their payout have proved to be excellent investments, but they can't prosper in the long run if the earnings aren't there.

Do you still recommend Fannie Mae? Worth OnLine Reader

Fannie Mae, the leader in the home-mortgage business, tops the list of my favorite companies of all time. I've owned it since the first Reagan administration. Lending money to home buyers is by its nature a boom-or- bust proposition, but Fannie Mae has figured out how to protect itself from the vicissitudes of interest rates.

In 1997, Wall Street analysts expect Fannie Mae to earn $2.80 a share, whereas a decade ago, the stock sold for $2.55 a share, adjusted for splits. That's what I call a remarkable investment: when a company's per-share earnings in a single year exceed the price you paid for the stock. No wonder the stock is up tenfold since 1987.

In spite of that incredible rise, Fannie Mae is still relatively cheap. The stock is selling at 13 times the 1997 estimated earnings, and profits are growing at 14 percent a year. On the other hand, the S&P; 500 is selling at 16 to 18 times earnings, while the historic growth rate of the average company is 8 to 9 percent. So you can buy Fannie Mae at its growth rate, whereas you have to pay twice the growth rate to buy shares in the average company in today's market.

Fannie Mae is far from your average company. For ten years in a row, it has posted record earnings -- the only major financial stock in the S&P; 500 ever to have done so. And the gain from the previous year has always been in double digits.

Fannie Mae isn't hurt by changes in interest rates, but a lot of people on Wall Street still worry that it will be. That's why the stock tends to drop whenever there's speculation that interest rates will rise. Another chronic worry is homeowners' defaulting on their mortgages, but Fannie Mae's delinquency rate is a negligible 0.56 percent.

A third worry surfaces from time to time: The government will ruin a good thing. Fannie Mae had its start in the depression, lending money to buyers who otherwise couldn't afford a home. Its original charter gave it a status much like a government agency, and though Fannie Mae is now a private corporation, it still is able to borrow money more cheaply than other companies. A faction in Congress periodically makes noises about altering the terms, imposing a Fannie Mae tax, or ending the relationship altogether; earlier this year, Congress held hearings on the subject.

Personally, I can't see how it would help anybody to reform Fannie Mae. The company pays more than $1 billion a year in taxes, which makes it one of the five biggest taxpayers in the U.S. In March 1994, it announced a program to finance $1 trillion worth of low- and moderate- income housing by the year 2000, and the program is right on track.

Ultimately, homeowners would pay the price for any change in Fannie Mae's status. As it is, the company is continuing to do good by doing well. Along with Freddie Mac, Fannie Mae is a prominent resident of the Lynch-family portfolio.

Peter Lynch writes "Investor's Edge" with John Rothchild and is vice- chairman of Fidelity Management and Research. Lynch and Rothchild's third book, Learn to Earn, was published earlier this year by Simon & Schuster.

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97/03

Peter Lynch: Use Your Edge

By Peter Lynch

What's the best way to invest $1 million? Tip one: Don't buy stocks on tips alone. If your only reason for picking a stock is that an expert likes it, then what you really need is paid professional help. Mutual funds are a great idea (I ran one once) for folks who want this sort of assistance at a reasonable price.

Still, I'm not convinced that having 4,000 equity funds in this country is an entirely positive development. True, most of the cash flooding into these funds comes from retirement and pension contributions, where people can't pick their own stocks. But some of it also has to be pouring in from former stock pickers who failed to invest wisely on their own account and have given up trying.

When people find a profitable activity -- collecting stamps or rugs, buying old houses and fixing them up -- they tend to keep doing it. Had more individuals succeeded at individual investing, my guess is they'd still be doing it. We wouldn't see so many converts to managed investment care, especially not in the greatest bull market in U.S. history. Halley's comet may return ten times before we get another market like this.

If I'm right, then large numbers of investors must have lost money outright or badly trailed a market that's up eightfold since 1982. How did so many do so poorly? Maybe they traded a new stock every week. Maybe they bought stocks in companies they knew little about, companies with shaky prospects and bad balance sheets. Maybe they didn't follow these companies closely enough to get out when the news got worse. Maybe they stuck with their losers through thin and thinner, without checking the story. Maybe they bought stock options. Whatever the case, they failed at navigating their own course.

At the risk of repeating myself, I'm convinced that this type of failure is unnecessary -- that amateurs can not only succeed on their own but beat the Street by (a) taking advantage of the fact that they are amateurs and (b) taking advantage of their personal edge. Almost everyone has an edge. It's just a matter of identifying it.

While a fund manager is more or less forced into owning a long list of stocks, an individual has the luxury of owning just a few. That means you can afford to be choosy and invest only in outfits that you understand and that have a superior product or franchise with clear opportunities for expansion. You can wait until the company repeats its successful formula in several places or markets (same-store sales on the rise, earnings on the rise) before you buy the first share.

If you put together a portfolio of five to ten of these high achievers, there's a decent chance one of them will turn out to be a 10-, a 20-, or even a 50-bagger, where you can make 10, 20, or 50 times your investment. With your stake divided among a handful of issues, all it takes is a couple of gains of this magnitude in a lifetime to produce superior returns.

One of the oldest sayings on Wall Street is "Let your winners run, and cut your losers." It's easy to make a mistake and do the opposite, pulling out the flowers and watering the weeds. Warren Buffett quoted me on this point in one of his famous annual reports (as thrilling to me as getting invited to the White House). If you're lucky enough to have one golden egg in your portfolio, it may not matter if you have a couple of rotten ones in there with it. Let's say you have a portfolio of six stocks. Two of them are

average, two of them are below average, and one is a real loser. But you also have one stellar performer. Your Coca-Cola, your Gillette. A stock that reminds you why you invested in the first place. In other words, you don't have to be right all the time to do well in stocks. If you find one great growth company and own it long enough to let the profits run, the gains should more than offset mediocre results from other stocks in your portfolio.

A lot of people mistakenly think they must search far and wide to find a company with this sort of potential. In fact, many such companies are hard to ignore. They show up down the block or inside the house. They stare us in the face.

This is where it helps to have identified your personal investor's edge. What is it that you know a lot about? Maybe your edge comes from your profession or a hobby. Maybe it comes just from being a parent. An entire generation of Americans grew up on Gerber's baby food, and Gerber's stock was a 100-bagger. If you put your money where your baby's mouth was, you turned $10,000 into $1 million. Fifty-baggers like Home Depot, Wal-Mart, and Dunkin' Donuts were obvious success stories to large crowds of do-it-yourselfers, shoppers, and policemen. Mention any of these at a party, though, and you're likely to get the predictable reaction: "Chances like that don't come along anymore."

Ah, but they do. Take Microsoft -- I wish I had.

I avoided buying technology stocks if I didn't understand the technology, but I've begun to rethink that rule. You didn't need a Ph.D. in programming to recognize the way computers were becoming a bigger and bigger part of our lives, or to figure out that Microsoft owned the rights to MS-DOS, the operating system used in a vast majority of the world's PCs.

It's hard to believe the almighty Microsoft has been a public company for only 11 years. If you bought it during the initial public offering, at 78 cents a share (adjusted for splits), you've made 100 times your money. But Apple was the dominant company at the time, so maybe you waited until 1988, when Microsoft had had a chance to prove itself.

By then, you would have realized that IBM and all its clones were using Microsoft's operating system, MS-DOS. IBM and the clones could fight it out for market share, but Microsoft would prosper regardless of who won. This is the old combat theory of investing: When there's a war going on, don't buy the companies that are doing the fighting; buy the companies that sell the bullets. In this case, Microsoft was selling the bullets. The stock has risen 25-fold since 1988.

The next time Microsoft might have got your attention was 1992, when Windows 3.1 made its debut. Three million copies were sold in six weeks. If you bought the stock on the strength of that product, you've quadrupled your money to date. Then, at the end of 1995, Windows 95 was released, with more than 7 million copies sold in three months and 40 million copies as of this writing. If you bought the stock on the Windows 95 debut, you've doubled your money.

Many parents with children in college or high school (I'm one of them) have had to step around the wiring crews as they installed the newfangled campuswide computer networks. Much of this work is being done by Cisco Systems, a company that recently wired two campuses my daughters have attended. Cisco is another opportunity a lot of people had a chance to notice. Its earnings have been growing at a rapid rate, and the stock is a 100-bagger already. No matter who ends up winning the battle of the Internet, Cisco is selling its bullets to various combatants.

Computer buyers who can't tell a microchip from a potato chip still could have spotted the intel inside label on every machine being carried out of the computer stores. Not surprisingly, Intel has been a 25-bagger to date: The company makes the dominant product in the industry.

Early on, it was obvious Intel had a huge lead on its competitors. The Pentium scare of 1994 gave you a chance to pick up a bargain. If you bought at the low in 1994, you've more than quintupled your investment, and if you bought at the high, you've more than quadrupled it.

Physicians, nurses, candy stripers, patients with heart problems -- a huge potential audience could have noticed the brisk business done by medical-device manufacturers Medtronics, a 20-bagger, and Saint Jude Medical, a 30-bagger.

There are two ways investors can fake themselves out of the big returns that come from great growth companies.

The first is waiting to buy the stock when it looks cheap. Throughout its 27-year rise from a split-adjusted 1.6 cents to $23, Wal-Mart never looked cheap compared with the overall market. Its price-to-earnings ratio rarely dropped below 20, but Wal-Mart's earnings were growing at 25 to 30 percent a year. A key point to remember is that a p/e of 20 is not too much to pay for a company that's growing at 25 percent. Any business that can manage to keep up a 20 to 25 percent growth rate for 20 years will reward shareholders with a massive return even if the stock market overall is lower after 20 years.

The second mistake is underestimating how long a great growth company can keep up the pace. In the 1970s I got interested in McDonald's. A chorus of colleagues said golden arches were everywhere and McDonald's had seen its best days. I checked for myself and found that even in California, where McDonald's originated, there were fewer McDonald's outlets than there were branches of the Bank of America. McDonald's has been a 50-bagger since.

These "nowhere to grow" stories come up quite often and should be viewed skeptically. Don't believe them until you check for yourself. Look carefully at where the company does business and at how much growing room is left. I can't predict the future of Cisco Systems, but it doesn't suffer from a lack of potential customers: Only 10 to 20 percent of the schools have been wired into networks, and don't forget about office buildings, hospitals, and government agencies nationwide. Petsmart is hardly at the end of its rope -- its 320 stores are in only 34 states.

Whether or not a company has growing room may have nothing to do with its age. A good example is Consolidated Products, the parent of the Steak & Shake chain that's been flipping burgers since 1934. Steak & Shake has 210 outlets in only 12 states; 78 of the outlets are in St. Louis and Indianapolis. Obviously, the company has a lot of expansion ahead of it. With 160 continuous quarters of increased earnings over 40 years, Consolidated has been a steady grower and a terrific investment, even in a lousy market for fast food in general.

The best companies often thrive even as their competitors struggle to survive. Until recently, the airline sector has been a terrible place to put money, but if you had invested $1,000 in Southwest AirlinesSouthwest Airlines in 1973, you would have had $460,000 after 20 years. Big Steel has disappointed investors for years, but NucorNucor has generated terrific returns. Circuit CityCircuit City

has done well as other electronics retailers have suffered. While the Baby Bells have toddled, a new competitor, WorldCom, has been a 20-bagger in seven years.

Depressed industries, such as broadcasting and cable television, telecommunications, retail, and restaurants, are likely places to start a research list of potential bargains. If business improves from lousy to mediocre, investors are often rewarded, and they're rewarded again when mediocre turns to good and good turns to excellent. Oil drillers are in the middle of such a recovery, with some stocks delivering tenfold returns in the past 18 months. Yet it took a decade of lousy before they even got to mediocre. Readers of my column in Worth learned of the potential in this long-suffering sector in February 1995.

Retail and restaurants are two of the worst-performing industries in recent memory, and both are among my favorite research areas. I've taken a beating in a number of retail stocks (some of which I still like and have continued to buy), but the general decline hasn't stopped StaplesStaples, BordersBorders, Petsmart, Finish Line, and Pier 1 ImportsPier 1 Imports from rewarding shareholders. Two of my daughters and my wife, Carolyn, have continued to shop at Pier 1, reminding me of its popularity. The stock has doubled in the past 18 months.

A glut in casual-dining outlets didn't hurt Outback SteakhouseOutback Steakhouse, and a surplus of pizza parlors didn't bother Papa John's, whose stock was a double last year. CKE Restaurants -- whose operations include the Carl's Jr. restaurants -- has been a profitable turnaround play in California.

So far, we've been talking about growth companies on the move, but even in this so-called extravagant market, there are plenty of bargains among the laggards. Of the nearly 4,000 IPOs in the past five years, several hundred have missed the rally on Wall Street. From the class of 1995, 37 percent, or 202 companies, are selling below their IPO price. From the class of 1996, 33 percent, or 285, now trade below their offering price. So much for the average investor's never having a chance to profit from an offering. In more than half the cases, you can wait a few months and buy these stocks cheaper than the institutions that were cut in on the original deals.

As the Dow has hit new records week after week, many small companies have been ignored. In 1995 and 1996, the Standard & Poor's 500 Stock Index was up 69 percent, but the Russell 2000 index of smaller issues was up only 44 percent. And while the Nasdaq market rose 25 percent in 1996, a lot of this gain can be attributed to just three stocks: Intel, Microsoft, and Oracle. Half the stocks on the Nasdaq were up less than 6.9 percent during 1996.

That's not to say owning these laggards will protect you if the bottom drops out of the market. If that happens, the stocks that didn't go up will go down just as hard and fast as the stocks that did. I learned that lesson in the 1971–73 bear market. Before the selling was over, companies that looked cheap by any measure got much cheaper. McDonald's dropped from $15 a share to $4. I thought Kaiser Industries was a steal at $13, but it also fell to $4. At that point, this asset-rich conglomerate, with holdings in aluminum, steel, real estate, cement, fiberglass, and broadcasting, was trading at a market value equal to the price of four airplanes.

Should we all exit the market to avoid the correction? Some people did that when the Dow hit 3000, 4000, 5000, and 6000. A confirmed stock picker sticks with stocks until he or she can't find a single issue worth buying. The only time I took a big position in bonds was in 1982, when inflation was running at double digits and long-term U.S. Treasurys were yielding 13 to 14 percent. I didn't buy bonds for

defensive purposes. I bought them because 13 to 14 percent was a better return than the 10 to 11 percent stocks have returned historically. I have since followed this rule: When yields on long-term government bonds exceed the dividend yield on the S&P; 500 by 6 percent or more, sell stocks and buy bonds. As I write this, the yield on the S&P; is about 2 percent and long-term government bonds pay 6.8 percent, so we're only 1.2 percent away from the danger zone. Stay tuned.

So, what advice would I give to someone with $1 million to invest? The same I'd give to any investor: Find your edge and put it to work by adhering to the following rules:

With every stock you own, keep track of its story in a logbook. Note any new developments and pay close attention to earnings. Is this a growth play, a cyclical play, or a value play? Stocks do well for a reason and do poorly for a reason. Make sure you know the reasons.

Pay attention to facts, not forecasts.

Ask yourself: What will I make if I'm right, and what could I lose if I'm wrong? Look for a risk-reward ratio of three to one or better.

Before you invest, check the balance sheet to see if the company is financially sound.

Don't buy options, and don't invest on margin. With options, time works against you, and if you're on margin, a drop in the market can wipe you out.

When several insiders are buying the company's stock at the same time, it's a positive.

Average investors should be able to monitor five to ten companies at a time, but nobody is forcing you to own any of them. If you like seven, buy seven. If you like three, buy three. If you like zero, buy zero.

Be patient. The stocks that have been most rewarding to me have made their greatest gains in the third or fourth year I owned them. A few took ten years.

Enter early -- but not too early. I often think of investing in growth companies in terms of baseball. Try to join the game in the third inning, because a company has proved itself by then. If you buy before the lineup is announced, you're taking an unnecessary risk. There's plenty of time (10 to 15 years in some cases) between the third and the seventh innings, which is where the 10- to 50-baggers are made. If you buy in the late innings, you may be too late.

Don't buy "cheap" stocks just because they're cheap. Buy them because the fundamentals are improving.

Buy small companies after they've had a chance to prove they can make a profit.

Long shots usually backfire or become "no shots."

If you buy a stock for the dividend, make sure the company can comfortably afford to pay the dividend out of its earnings, even in an economic slump.

Investigate ten companies and you're likely to find one with bright prospects that aren't reflected in the price. Investigate 50 and you're likely to find 5.

Peter Lynch owns shares in the following companies mentioned above: Outback Steakhouse, Pier 1 Imports, Consolidated Products, Staples, and WorldCom. KEYWORDS: Peter Lynch, million, Fidelity Magellan

97/05

Send in the Money!

By Peter Lynch

The virtue of thrifts, take four. You might not have been paying attention, but your neighbors have.

Since my very first Worth article, in the summer of 1992, I've been talking about the remarkable opportunity presented to investors when thrifts (the term covers savings and loans, savings banks, and some other institutions) go public. Thrift conversions are a rare and lovely reversal of the normal order: a great opportunity that seeks you.

But even I didn't realize quite how exceptional these investments have been until recently, when some questions from readers inspired me to make a call to SNL Securities, the financial-advisory firm that has been my leading source on all things thrift related. I asked SNL to look at the five calendar years starting in 1992. It turns out that, from 1992 through 1996, 445 thrifts went public. Of the 313 for which current pricing is available, the average increase in value is 98 percent. But that's not even the most remarkable part of the story. Of these 313 thrifts, only five are trading below their initial-public-offering price. Two are trading at their IPO price. So 306 of 313 are winners. You'll have to do a lot of looking to find another group in which 97.7 percent of the stocks have risen in value over five years. (As for the 132 thrifts no longer trading, most of them have been bought out by banks and other thrifts. Given the prices they've been bringing, that's good news.)

In what sense is thrift conversion an opportunity that seeks out the investor rather than vice versa? In the sense that if you are a depositor in a thrift that is planning a conversion everything you need to know will come through your mail chute. Anytime a thrift goes public, depositors get first crack--the only crack, usually--at buying shares at the IPO price. For most of these depositors, it's the first and only time they've been guaranteed precedence over the pros who usually make their way to the front of every line. Unfortunately, most depositors don't read the news they get from their thrift, or don't quite believe it, or for some other reason don't say yes to the opportunity. No one has exact numbers, but the guess is that 90 percent or more of thrift depositors don't buy shares when their thrifts go public. It's a real shame. In 1995 and 1996, thrift IPOs experienced an average first-day gain of 14.2 percent, and in the fourth quarter of last year, the average was 25.5 percent. Imagine someone who holds a savings account at one of those thrifts. Say the account pays 3.5 percent annually. The depositor can take that money out of savings for one day to make six years' worth of interest.

That's why I've made it my business to encourage investors to scout the places they live, work, and vacation for thrifts that aren't publicly owned and to consider opening accounts in them. If you've kept a reasonable amount of money (generally a couple thousand dollars) in a thrift for a

reasonable length of time (generally a year), you'll be given a shot at shares should the thrift go public. And if it doesn't, you'll have earned some interest while you waited.

The pace of conversion slowed somewhat last year--74 thrifts went public, compared with 97 in 1995--but the fourth quarter was strong, and SNL notes that the thrifts going public now tend to be among the largest and best capitalized. SNL still counts 925 privately held thrifts. It would be a mistake to assume that all of these are moving inexorably toward public status, but a large number will choose that course eventually, because like so many small businesses they need access to public capital in order to compete and grow. As it has twice before, SNL has come up with a list of candidates for conversion. (See "Top 50 Conversion Candidates" on page 36.) No guarantees, of course, but of the 189 thrifts to appear on SNL's previous lists, published in 1994 and 1995 (11 thrifts were on both lists), 24 have already made the conversion.

One of those, from the 1994 list, is the Roslyn Savings Bank (now Roslyn Bancorp) of Roslyn, New York, which went public in January 1997. Roslyn is a good study on a couple of levels. First, it demonstrates that the rules of the game have changed a little. Second, and more important, it shows how and why a thrift IPO works as an investment.

To set the stage: Roslyn was a big thrift, the second largest yet to go public, with $1.8 billion in total assets. Just as important, it had more than 112,000 depositors and was in what Chris Smith of SNL calls a "conversion-savvy neighborhood." (Greater New York City, in other words.) What's more, a couple of other large, successful conversions had recently taken place in the area, and the media were in high alert. Stories about Roslyn's impending IPO ran in all the papers and on the local news.

There was one more factor at play in Roslyn: the heavy interest of what Chris Smith calls "professional depositors." These are people who, rather than looking locally for thrifts that might someday go public, look all over the country. They leave small deposits wherever they can, and that certainly included Roslyn.

So what happened when Roslyn announced it was ready to go public, with 42.3 million shares available at $10 apiece? Answer: The thrift received buy orders for $1.7 billion worth of shares. As a matter of fact, it was flooded with $1.7 billion in cash, because the only way to order shares for a thrift IPO is to send in the money. Send in the money: Now there's a good barometer of investor passion if ever I saw one.

Oversubscription--more buy orders than shares offered--is a common enough phenomenon these days with thrift conversions, but not on the scale of the Roslyn IPO. To distribute its shares, Roslyn had to establish criteria for deservedness, based on the size of deposits. Basically, for every $170 on deposit, an investor was allowed to buy 100 shares. A deposit of $1,000 entitled you to buy roughly 588 shares; $10,000 was good for about 5,880 shares. To buy 67,500 shares, the maximum number available to an individual, you had to have a little better than $110,000 on deposit with Roslyn.

The formula reflected Roslyn's attitude toward professional depositors-- which was, basically, the heck with them. Pros who had never committed more than a few hundred dollars to the

bank's well-being walked away frustrated, while most people who had maintained real relationships with the bank were satisfied. Chris Smith says professional depositors are the largest reason most thrifts now require higher deposits to secure a full allocation of stock than their peers did a few years back. Still, the barriers aren't terribly high. "In the majority of cases," Smith says, "a $1,000 to $2,000 account balance should be sufficient to receive most or all of the stock you are entitled to, though sometimes you will need more."

Two notes: First, a lot of thrifts have begun rejecting the money of people they think may be professional depositors, usually by requiring that new customers live or work in the bank's home county. Second, and more important, it's a shame Roslyn wasn't oversubscribed by more than it was. Never mind the pros. More ordinary depositors should have been in there requesting all the shares they could afford. Those $10 Roslyn shares were worth $15.70 after the first day of trading--a 57 percent gain.

Why did Roslyn pop that much on its first day out? The first part of the answer has to do with all the attention Roslyn received and its strength in its market. The second part has to do with the nature of thrifts themselves.

A thrift is essentially a cooperative--it's owned by no one, really. So what happens with the money raised in an IPO if there are no founders or owners to pay off? The money goes right into the company till, and the company's net worth jumps by that amount. The new shareholders have just given themselves a great thrift-warming present. Investors in the secondary market see this and bid up the price.

In Roslyn's case, the thrift had a stated net worth of about $222 million at the time of conversion. The IPO raised $423 million. Boom-- Roslyn was now worth $645 million. Let the bidding begin. And though Roslyn's one-day pop might suggest otherwise, this IPO was conservatively priced. The stock was priced at 73.5 percent of book value--slightly higher than the 1996 industry average of 70.5 percent and a lot higher than was typical in the early part of this decade, when depositors were sometimes able to buy a thrift for half of what it was worth.

Take a look at the list of SNL's conversion candidates and see if any are your neighbors. Are any near the place where you work? Or near your regular vacation spot? If so, I can't imagine why they wouldn't welcome you as a new account holder. What thrifts are looking for, very simply, are depositors with legitimate connections to the institution and the community.

Here is how to think about the measures listed on the chart. "Total Assets" is self-explanatory. Beyond that:

*You want to see a high equity-to-assets ratio. This is the most basic measure of a bank's strength--its firepower, if you will. Anything below a 5 is cause for concern. Citicorp, one of the strongest of the big banks, has a ratio of 7.39. Some thrifts, because they've retained a lot of earnings over the years and haven't been aggressive about making loans, have ratios of 10 or even 20 or more.

*You also want to see a high return on assets, the basic measure of profitability. A return on assets of zero translates into zero profits. Healthy thrifts and banks have a return on assets of at least 1 percent.

There is, however, a potentially profitable exception. Say a thrift's return on assets is low, maybe even below zero, but is moving up. Take a quick look at the equity-to-assets ratio. If it's high, you may have found a rewarding combination--the thrift may have enough equity to sustain it through a recovery. When I see a thrift or bank with a lot of equity and a low return on assets, my first question is: If this thing can turn around and make 1 percent on assets, what will it earn?

*You want a low percentage of nonperforming assets--loans that won't be repaid at 100 cents on the dollar. If a thrift has mostly written mortgages, you shouldn't see a problem. Commercial lending, on the other hand, is a hole many thrifts fell into during the 1980s. Nonperforming assets above 0.5 percent should make you wonder just what this thrift has been up to.

Another profitable exception: A very strong equity-to-assets standing gives a thrift a couple of ways to clean up a nonperforming-assets problem. It can write off the bad loans without too much damage to its equity-to-assets ratio. It can even sell the loans at 50 cents on the dollar and put the proceeds to work creating earnings.

That's a starting point. A great deal more information will become available should your thrift file plans to convert. You should confirm, at the very least, that the bank's officers and directors are buying stock in the offering and that they were involved in pricing it. It's worth something to know you're all on the same side of the table.

Let's look at the worst-case scenario in a conversion, because I don't want to give the impression that this is the one investment you don't have to think about and can't lose money on. (I haven't found that investment yet.) Let's imagine that a public offering is the thrift's last chance of getting enough money to stay afloat--it has written off so many commercial loans that it actually has no net worth, and at the same time it isn't making any money. Such a thrift may use an IPO to raise $40 million and be worth $30 million when it's over. You don't want any part of that. Fortunately, that's a rare case these days.

Traditionally, when I look at the issue of thrift conversions, I also look at thrifts that are already publicly traded. That short-term pop from an IPO is nice, but don't let it distract you from the long-term potential of thrifts, whether or not you buy them young. One last statistic from SNL proves this point: The five best-performing converted thrifts of the past five years have returned on average 558.5 percent. So what if you missed the IPO? Imagine if you'd caught even the last half of the ride.

In the past, the research lists have done pretty well, as you'll see in the three tables labeled "Update." On this page is a 1997 research list containing ten new names. Of these, I own Ambanc and Cameron Financial.

For all the stocks on this list, the most alluring quality is a high equity-to-assets ratio--as high as 24.7 in the case of Cameron. As I've noted, overcapitalization covers a lot of sins. And each of

these stocks sells at or below book value in an industry in which the typical thrift trades at 1.23 times book. On the other hand, none of these stocks can truly be called a bargain--they're all fully priced on current earnings. On past research lists, at least a few stocks have traded at single- digit price-to-earnings ratios, but that's not the case this time. Again, this is a research list. Don't invest in any of these companies unless and until you learn more about them--and in particular about whether their strengths are offset by their weaknesses.

I mentioned earlier that a lot of thrifts disappear from the stock tables because they're bought up. Six of the 10 thrifts from my 1992 research list have been acquired or have merged with other institutions, as have 5 of the 15 from the 1994 list and 2 of the 15 from the 1995 list. In most cases, this has produced another quick pop for investors, because thrifts are almost always acquired at prices comfortably in excess of book value. The average takeover price last year, for example, was 149 percent of book, and early this year, Summit Bancorp, a large New Jersey bank, agreed to pay more than 2.3 times book value to acquire Collective Bancorp.

Some people--professional depositors, certainly--are saying that thrift investing isn't what it used to be now that the rules on IPOs are tightening and more people are in on the secret. I don't agree. I see years' worth of opportunity in such offerings, and I see continued consolidation.

Late last year, I even saw a couple pieces of legislative good news. The most important of these, the Deposit Insurance Funds Act of 1996, concerns federal insurance for deposits. It hit thrifts with a big onetime charge to gas up the deposit-insurance fund, but in return it dropped the ongoing premium. Thrifts used to pay 23 to 31 basis points per dollar on deposit; now they pay zero to 27 points, and 95 percent of them pay zero. Imagine a thrift with a return on assets of 1 percent, or 100 basis points. If you lower the thrift's insurance expenses--which come out of earnings--by 23 basis points, those earnings go up by 23 percent.

Thrift investors have been living through a golden period--five solid years of a decent economy and low inflation. It would be foolish not to think about what happens when the economy begins to give out. A recession would be tough on thrifts (and on a lot of other stocks, of course). A sharp jump in inflation would be tough on thrifts, too (and on nearly all stocks). In either case, the 1997 research list probably wouldn't be a star group, though it could very well be when the economic weather turned again.

Thrifts that come public during a downturn will still be good investments. Maybe fewer thrifts will convert in that kind of environment, but maybe, on the other hand, oversubscription will ease up, and you, as a depositor, will be able to buy more shares. Whatever happens, keep checking the mail.

Peter Lynch is vice-chairman of Fidelity Management and Research. His third book, Learn to Earn, was published in 1996 by Simon & Schuster.

Update: the 1992 List

Thrift	Research Price	Recent Price	Percent gain
Ameriana Bancorp (Nasdaq: ASBI)	$8.33	$15.75	89%

Bankers Corp. (Nasdaq: BKCO)	9.19	25.00	172
Bell Bancorp*	17.38	37.50	116
Charter FSB Bancorp**	15.50	45.05	191
Eagle Financial (Nasdaq: EGFC)	13.13	29.13	122
Germantown Savings***	23.50	62.00	164
Liberty Bancorp#	16.25	53.29	222
NS Bancorp##	24.13	53.87	123
People's Savings Fin. (Nasdaq: PBNB)	14.00	31.00	121
UF Bancorp###	16.63	54.13	226

Research prices as of 7/31/92. Recent prices as of 3/13/97. The thrifts whose names appear in green have been bought for cash or stock since 1992. *Bell was acquired by Standard Federal Bancorp for $37.50 cash a share in June 1996. **Charter was acquired by Sovereign Bancorp on 11/1/ 94; recent price reflects the exchange of Charter's stock. ***Germantown was acquired by CoreStates Financial for $62 cash a share on 12/2/94. #Liberty merged with Banc One on 12/30/96; recent price reflects the exchange of Liberty's stock. ##NS Bancorp merged with MAF Bancorp on 5/ 30/96; recent price reflects the exchange of NS's stock. ###UF Bancorp was acquired by CNB Bancshares on 8/4/95; recent price reflects the exchange of UF's stock.

Update: the 1994 List

Thrift	Research Price	Recent Price	Percent Gain
Ameribanc Investors Group*	$1.81	$3.00	66%
Astoria Financial (Nasdaq: ASFC)	14.06	39.56	181
Bay View Capital (Nasdaq: BVFS)	19.75	54.63	177
California Financial (Nasdaq: CFHC)	16.50	29.00	76
CENFED Finan. Corp. (Nasdaq: CENF)	15.91	33.63	111
Crossland Savings**	33.50	41.50	24
FFY Financial Corp. (Nasdaq: FFYF)	14.63	25.25	73
Fidelity New York, SFB***	17.25	29.00	68
GP Financial#	18.50	56.50	205
Lakeview Savings Bk. (Nasdaq: LVSB)	10.70	33.50	213
Mid-Iowa Financial (Nasdaq: MIFC)	3.63	8.25	128
North Side Savings Bank##	17.91	64.38	260
Pamrapo Bancorp (Nasdaq: PBCI)	14.63	23.25	59
Queens Cty. Bancorp (Nasdaq: QCSB)	18.13	57.75	219
Sunrise Federal ###	16.00	32.00	100

Research prices as of 3/31/94. Recent prices as of 3/13/97. The thrifts whose names appear in orange have been bought for cash or stock since 1994.*Ameribanc was acquired by First Union for $3 a share in cash on 4/ 1/95. **Crossland was acquired by Republic New York for $41.50 a share in cash on 1/31/95. ***Fidelity was acquired by Astoria Financial for $29 a share in cash

on 1/31/95. #GP Financial changed its name to GreenPoint Financial. ##North Side was acquired by North Fork Bancorp on 1/2/97; recent price reflects exchange of North Side's stock. ###Sunrise was acquired by Reliance Bancorp for $32 a share on 1/11/96.

Update: the 1995 List

Thrift	Research Price	Recent Price	Percent Gain
Albank Financial Corp. (Nasdaq: ALBK)	$25.00	$34.75	39%
Astoria Financial (Nasdaq: ASFC)	21.31	39.56	86
Cameron Financial (Nasdaq: CMRN)	14.50	16.38	13
Carver Fed Savings (Nasdaq: CARV)	9.88	10.13	3
Charter One Financial (Nasdaq: COFI)	28.09	45.25	61
First Federal Financial (NYSE: FED)	15.63	27.25	74
GP Financial*	27.63	56.50	105
Home Financial Corp.**	15.38	19.68	28
ISB Financial (Nasdaq: ISBF)	15.75	26.13	66
Leader Financial***	34.63	68.63	98
Portsmouth Bank (Nasdaq: POBS)	13.28	15.75	19
Quaker City (Nasdaq: QCBC)	14.00	19.00	36
Queens Cty. Bancorp (Nasdaq: QCSB)	29.91	57.75	93
Standard Federal Bank (NYSE: SFB)	39.00	57.75	48
Washington Mutual (Nasdaq: WAMU)	26.50	51.63	95

Research prices as of 9/29/95. Recent prices as of 3/13/97. Thrifts whose names appear in green have been bought for cash or stock since 1995. *GP Financial changed its name to GreenPoint Financial. **Home Financial was acquired by First Union on 11/26/96; recent price reflects exchange of Home's stock. ***Leader was acquired by Union Planters on 10/1/96; recent price reflects exchange of Leader's stock.

Top 50 conversion candidates

Rank	Institution	Location
1	Hudson City Savings Bank	Paramus, NJ
2	Third FS&LA;	Cleveland
3	Capitol FS&LA;	Topeka, KS
4	Independence Savings Bank*	Brooklyn
5	Investors Savings Bank*	Millburn, NJ
6	Dollar Bank, FSB	Pittsburgh
7	Eastern Bank*	Lynn, MA
8	Provident Savings Bank	Jersey City
9	New Haven Savings Bank	New Haven, CT
10	Ridgewood Savings Bank	Ridgewood, NY

11	Staten Island Savings Bank	Stapleton, NY
12	Columbia Savings Bank*	Fair Lawn, NJ
13	Beneficial Savings Bank	Philadelphia
14	American Savings Bank	New Britain, CT
15	Middlesex Savings Bank	Natick, MA
16	Liberty Bank	Middletown, CT
17	Home Federal Bank of Tennessee, FSB	Knoxville, TN
18	North Shore Bank, FSB	Brookfield, WI
19	Mutual Saving	Milwaukee
20	Financial FT&SB; of Olympia Fields	Olympia Fields, IL
21	Lockport Savings Bank	Lockport, NY
22	Home Savings & Loan Co.	Youngstown, OH
23	Cambridge Savings Bank	Cambridge, MA
24	Compass Bank for Savings*	New Bedford, MA
25	Savings Bank of Manchester	Manchester, CT
26	Richmond County Savings Bank	W. New Brighton, NY
27	Savings Bank of Utica	Utica, NY
28	First Federal Lincoln Bank	Lincoln, NE
29	Salem Five Cents Savings Bank	Salem, MA
30	Maspeth FS&LA;	Maspeth, NY
31	Spencer Savings Bank, SLA	Garfield, NJ
32	Bangor Savings Bank	Bangor, ME
33	First FS&LA;	Lakewood, OH
34	Yakima FS&LA;	Yakima, WA
35	Kearny Federal Savings Bank	Kearny, NJ
36	Piedmont FS&LA;	Winston-Salem, NC
37	Cape Cod Five Cents Savings Bank	Harwich Port, MA
38	Brookline Savings Bank	Brookline, MA
39	Troy Savings Bank	Troy, NY
40	Plymouth Savings Bank	Wareham, MA
41	Hudson City Savings Institution	Hudson, NY
42	Citizens Financial Services, FSB	Hohman, IN
43	Union Savings Bank of Danbury	Danbury, CT
44	Franklin FS&LA;	Glen Allen, VA
45	Provident Bank	Haverstraw, NY
46	Keystone Savings Bank	Bethlehem, PA
47	Fidelity Homestead Assn.	New Orleans
48	Oritani Savings Bank	Hackensack, NJ

49	Gate City Federal Savings Bank	Fargo, ND
50	Liberty Bank for Savings	Chicago

*Indicates a wholly owned subsidiary of a mutual holding company. Source: SNL Securities.

1997 Research List

Institution (Exchange: Ticker)	**State**	**Recent Price**	**Equity to Assets**	**Price to Book**	**P/E Ratio**	**Assets ($mil)**
Ambanc (Nasdaq: AHCI)	NY	14.25	14.2	98.8	29.7	496.5
Bank West Financial (Nasdaq: BWFC)	MI	11.63	15.9	93.2	13.8	143.2
Cameron Financial (Nasdaq: CMRN)	MO	16.38	24.7	98.4	17.1	191.9
Classic Bancshares (Nasdaq: CLAS)	KY	13.50	14.9	93.2	16.1	128.4
MBLA Financial (Nasdaq: MBLF)	MO	20.75	13.6	97.7	14.0	208.9
MFB (Nasdaq: MFBC)	IN	18.88	15.4	97.1	18.2	223.9
Mississippi View Holding (Nasdaq: MIVI)	MN	15.13	18.5	99.2	18.0	70.3
Pennwood Bancorp (Nasdaq: PWBK)	PA	14.00	20.1	91.1	15.2	46.7
StateFed Financial (Nasdaq: SFFC)	IA	17.75	17.8	94.5	13.1	82.8
Tri-County Bancorp (Nasdaq: TRIC)	WY	18.50	15.3	85.7	12.5	85.9/td>

Recent prices as of 3/13/97. Source: SNL Securities.

97/08

The REIT Craze

By Peter Lynch

I wish I had a few dollars for every time I've been asked in the past year, "Hey, should I buy a REIT?" I'd take that money and buy...well, maybe shares in a real-estate investment trust. A REIT.

But not just any REIT. I'd need to do some looking around and some reading, and I'd want to talk with people who know more than I do. In other words, I'd expect to put in a reasonable amount of work before I could find a REIT or two that I'd want to invest in. The question, however--"Should I buy a REIT?"--too often assumes that this work isn't necessary, apparently because each REIT is more miraculous than the next. I have a feeling the REIT is the most recent example of a recurring phenomenon: the investment that people think will make money for them whether or not they really understand it.

I wish that were true. I could go down the hall right now and tell a lot of people to stop working so hard. But investing doesn't have much to do with miracles. Real estate is a cyclical business, and most REITs are enjoying a very profitable part of the cycle. Eventually the wheel will turn, and then we'll see which REITs actually have the best holdings, the best management, and the best honest-to-goodness long-term prospects. The happiest investors then will be those who didn't buy just any old REIT in 1997.

Much of the fogginess that surrounds REITs is owed to the fact that the category is relatively new and surprisingly small. The legislation that produced the REIT industry was signed in 1960, but it was 30 years before REITs could be called respectable, mainstream investment vehicles. Even now, there are only about 195 publicly traded REITs. The market capitalization of these 195 is about $94 billion, which means the entire publicly traded component of the industry is only about two- thirds the size of Microsoft. What do REITs own? Real estate, of course. But real estate in different forms, in different places, with different relations to economic cycles. The most traditional kind of REIT is one that owns office buildings or apartments or hotels. The newest kind--I kid you not--is one that holds prisons.

Here is a much-simplified version of how the most common kind of REIT, called an equity REIT, is set up and operates. The process begins with an initial public offering--let's say the management group of a new REIT sells ten million shares for $10 each. Then it borrows, to pick a conservative number, another $25 million. With that $125 million it builds or (more likely) buys income-producing property. The source of the income is rent--paid by families in apartments, companies in office towers, or stores in malls.

What actually defines a REIT is its lack of choice regarding the money it earns: Tax law requires that a REIT distribute at least 95 percent of its net income to shareholders as dividends. That sharply limits the REIT's options. But tax law giveth, too: REITs pay no federal income tax.

Equity REITs constitute about 89 percent of the REIT industry in terms of market capitalization. About half the remaining market cap is in mortgage REITs, which don't buy property but instead invest in mortgages taken out by builders and property owners--a demanding business that succeeds only if borrowers don't default and interest rates don't go sharply up or sharply down. The remaining REIT money is in so-called hybrids, which own property and also loan money.

By and large, individual investors are best off with equity REITs. If you're a shareholder in an equity REIT, you're a landlord. If you own shares in a mortgage REIT, you're a money lender who lives and dies with interest rates.

Within the equity sector, there are ten or so subsectors. The largest, with 43 REITs and about $21 billion in market capitalization, is retail: REITs that own shopping complexes of various sorts. Next, with 36 REITs, is residential: apartment buildings and complexes. Then industrial/ office: industrial parks and office buildings. There's also a lot of money invested in self-storage and health-care facilities (these REITs tend to own not hospitals and clinics but the ground beneath them).

Any subsector might very well have its own subsectors--in the retail subsector, for example, there are five REITs that own nothing but outlet centers. All this breaks down even further along geographic lines.

The National Association of Real Estate Investment Trusts (800-3-NAREIT or www.nareit.com) is the source for data on the REIT industry. NAREIT's industry-wide index showed a total return of 35.75 percent in 1996--12.79 percentage points better than the Standard and Poor's 500 Stock Index. The big winner, at 51.98 percent, was mortgage-backed securities, which isn't surprising given the relatively strong economy and steady interest rates. The best performer on the equity side was the office group, with a total return of 51.82 percent. Hotels did almost as well: 49.19 percent. Regional malls returned 44.63 percent.

This is the stuff that caught so many investors' eyes. Yet look at the return on those outlet-center REITs: just 3.51 percent. That's how it was possible to do badly in REITs even in a deliriously good year. And as so often happens, the REIT industry is coming down to earth just as attention on it is intensifying--through the first four months of 1997 the NAREIT index was down by a couple percentage points. How does an investor go about evaluating a REIT? The first step is to learn about the properties it holds. Visit them if you can. If the properties are apartment buildings, are they well maintained, do they command good prices, and are the vacancy rates low? If the properties are shopping centers, are the parking lots full and the retail spaces leased? Will the malls still be attractive to shoppers five or ten years down the line? Most important, what's the likelihood that competition will crop up?

That's the first level of examination. Here are additional points of focus:

LEASES. The key here is the relationship between a REIT's leases and local economic conditions. The best combination for a REIT is a market that is turning up and leases that are turning over. In that environment, a new lease is an opportunity to raise prices. You can get some information about a REIT's leases by calling the investor-relations office. But the more important side of the equation is the local markets, and that doesn't require any special knowledge or access. Let's say I'm considering an office-building REIT with a lot of properties here in Boston. I know the local office market is strong--I can read that in the paper. And if I look out my window I can see that there's nothing coming out of the ground. It would take years for a developer to put up new buildings to take advantage of the conditions my imaginary REIT is already enjoying. No one's going to sneak a 50-story office building past me.

The flip side of this happy scenario is one in which the local economy is headed south. If leases are turning over, they're going to be renewed at lower rates. There go your earnings. Even if the terms of the leases are relatively long, investors will see trouble coming and punish the stocks here and now.

GROWTH STRATEGIES. The best REITs don't want to just pay dividends. They want to grow--buy more properties, collect more rent, drive their stock prices up. That's not simple, given the requirement that REITs distribute 95 percent of net income. A REIT can't hold its dividend down for a few quarters while it accumulates cash to buy more property.

So how does a REIT grow? At least four ways: It borrows money; it pays the smallest dividend allowable by the law and acceptable to shareholders (and thereby retains a maximum of earnings); it sells property from its portfolio at a profit; and it issues more stock. An investor should learn which of these strategies a REIT is employing and to what extent.

Leverage is a basic fact of real-estate investing. So is cyclicity. And, given the combination of these two, so is volatility. Right now, aggressive REITs are using leverage to their advantage. That's fine, but they're going to have to be pretty quick on their feet to avoid being hoisted on that leverage when the cycle moves along. Conservative REIT analysts don't like to see debt that totals more than 40 percent of a REIT's estimated asset value.

Selling property can give earnings a kick if, first, the price is right and, second, the money is used to buy another property with a better upside. Stock issues can be good news, too, but only if the sale doesn't dilute the value of existing shares. In other words, any proceeds from the sale of new stock should be invested in property in a way that raises, or at least doesn't reduce, the REIT's overall rate of return. The worst kind of stock issue is one used to support faltering operations or prop up the dividend.

MULTIPLES. The stock tables in the newspaper show a price-to-earnings ratio for every listed REIT. People in the industry tend to ignore it-- for good reason. Different REITs figure earnings differently, so p/e ratio isn't much use for REIT-to-REIT comparison.

NAREIT has pushed its members to adopt a more meaningful measure called funds from operation. It may be a while before all REITs report FFO the same way, but price-to-FFO ratio is a reasonable measure of valuation and means of comparison. The average equity REIT now sells at about 11.3 times FFO.

Much as you might like the income, don't get too hung up on dividend yield. Some REITs distribute money well in excess of 100 percent of their net income (they do this by distributing a portion of the tax break for depreciation on their properties). That may attract investors, but the best REITs look for ways to use their cash for growth. In this environment, if you see a dividend above 8 percent, do some more research. You may be looking at a company that doesn't have a viable strategy. Or you may have found one that has been overlooked and undervalued.

Finally, examine the rate of growth for net income and FFO. The top companies show steady, sustainable growth.

INSIDE OWNERSHIP. I always feel better about a company when the managers have a financial stake in it. NAREIT suggests that management should own a minimum of 10 percent of the shares in any REIT. Sounds good to me.

The REIT craze is far from over. Last year produced six REIT initial public offerings. This year, there will probably be twice as many, including the largest ever, Boston Properties, started by publishing magnate Mortimer Zuckerman and scheduled to go public soon. REIT mutual funds are proliferating, too: There are now 58, and 19 of them are sold without front-end loads. If you believe in the idea of REIT investing

but aren't sure that you have an edge, or the time to take up another kind of investment research, consider letting the professionals do it for you.

Of course, picking a fund will take some research as well. REIT funds are no more alike than REITs are and no less subject to the basic rules of investing: Buy only what you understand, believe in, and intend to stick with--even when others are chasing the next miracle.

Peter Lynch is vice-chairman of Fidelity Management and Research. His third book, Learn to Earn, was published last year by Simon & Schuster. He writes "Investor's Edge" with Dan Ferrara. Research assistance provided by John Fried.

97/11

Keep Digging

By Peter Lynch

So your Krugerrands haven't panned out. It's still possible to uncover good gold-mining companies.

Let's try this again. back in June 1995, I made my pitch for gold in the pages of Worth. It seemed like the right time: Inflation was showing signs of life, and world gold demand was on the rise. Annual fabrication demand alone--for gold destined for actual use, primarily in jewelry and the electronics industry, as opposed to gold to be held in coins and ingots as investments--exceeded the amount being taken out of the ground. Simply on a supply-and-demand basis, it all seemed like a promising recipe for gold prices and hence for gold stocks and funds.

Well, I was right about the demand side of the equation but wrong about supply. Like most gold analysts and gold-fund managers, to say nothing of the long-suffering goldbugs, I didn't see some things coming. And therefore I didn't anticipate the way the price of gold would stagnate for a while, pop nicely higher for a while, and ultimately collapse like a central banker at the end of a long, hard week. In mid-1995, gold traded at a spot price of about $385 an ounce. It climbed in 1996 to $416. It dropped nearly $100 an ounce, to $318, by early this summer, and as I write, it's at $323.

The trend has been ugly, I know, but I think things may begin looking up for gold--and, more important for our purposes, for gold-mining companies. The best news is that if you buy the right companies the commodity price doesn't have to jump for the stocks to show a nice increase.

In the broadest sense, the problem with gold is that it is undergoing a re-evaluation. The central banks of many countries are wondering if gold's traditional role has any meaning in the modern global economy. For centuries, a country's gold reserve has been the representation of its wealth. The very definition of a devalued currency has been one that isn't backed by gold. But in some places the men with their hands on the levers are weakening in their faith. Maybe the best measure of economic strength, they're saying, is something less physical--purchasing power in the world's markets, perhaps. Maybe gold is just a metaphor--a metaphor that doesn't pay dividends or go up in value. The heck with it.

I've talked with people who think this reassessment of gold is savvy and long overdue and with people who think it's foolish, perhaps catastrophic. It's not important to take a position here. What's important is that in the past two years a number of central bankers have decided they didn't particularly care whether their vaults held gold anymore, and they sold (in some cases because they needed to raise cash). I said I had messed up the supply side of the scenario two years ago. That's a large part of what went wrong: Central banks unloaded gold at an accelerated pace.

The amount of gold dumped by the central banks wasn't enormous--they still hold 97.6 percent of the gold they held at the end of 1994. But that's not the point. Gold, much more so than any other commodity, is about sentiment and psychology. There's a sense that central banks aren't playing by the old rules.

Australia, for example, sold two-thirds of its reserves this summer--the government said it would rather buy foreign bonds, which at least pay some interest. Investors have seen this sea change and have asked a pretty fair question: If banks don't want gold, who the heck does? Gold has traditionally been regarded as an inflation hedge, but that is dependent on the same metaphor, the same set of assumptions. (Not to mention that inflation has been quiescent more or less worldwide.) To some people it has begun to appear that, as Jim Rogers said in Worth earlier this year, gold just doesn't work anymore.

I should touch on the infamous Bre-X Minerals scandal. You remember that: The company announced that it had found an enormous reserve in the jungles of Indonesia. And then it announced that there had been...a...mistake. There was no gold. Recriminations followed, to say nothing of lawyers. A company geologist leaped from a helicopter. The company itself has disappeared.

In real terms, this shouldn't have mattered very much. It was even possible to see the bad news as good news: No huge new reserve meant less new supply to dilute demand. But investors saw the scandal in the context of a market that had become odd and unpredictable. They saw it as just another thing not to like about gold. Bre-X didn't cause the collapse of gold prices and gold stocks, but it darkened an already negative atmosphere.

So where do I get the nerve to suggest that you look into gold stocks? I'd like to humbly point out that I was correct two years ago about the demand side of the gold equation. Every year since 1991, in fact, demand has outstripped what is known as the mine and scrap supply. Last year, the gap was about 8.4 million ounces, about 2.3 times the gap in 1994. Much of the demand comes from Asia--in particular India and China. The economies in those countries are increasing rapidly and producing a growing middle class. What are these people going to do with their wealth? They tend to live a long way from a Circuit City. Cars are still out of the question for many of them. If Indians and Chinese can't convert their money to stuff, as Americans so vigorously do, they're going to save it--and they still like to do that, in part, by buying high-karat gold jewelry. A lot of people think this demand, though it has proved price-sensitive, provides a bottom for the market.

The supply issue is probably better under control now, too. Beginning in 1980, when the price of gold shot up to $850, mining companies reacted as you might expect: They explored frantically, sunk new mines, re- opened old mines. They spared no expense, and why should they have? If you can get $850 an ounce, you can make a profit at almost any production cost.

Some of those mines are playing out now; they've had their eight or ten years of production. Others are too expensive to operate in a $330-an- ounce market. According to Gold Fields Mineral Services, a London-based research firm, the industry-wide total cost of getting an ounce of gold out of the ground has risen to an average of $317--a dollar less than the recent low spot price.

Even the great mines of South Africa are finally winding down. They've had amazing runs--100 years and more--but now the gold isn't coming as easily. Or as cheaply: Labor costs have gone in the opposite direction as gold prices. South Africa is not what it used to be as a gold producer. As for central-bank sell-offs, they probably won't be as numerous or have the same kind of impact in the future. Investors now understand that banks can sell. They also know there's a limit to how much they can sell. Australia's sale a few months ago was dramatic symbolically, but in relative terms the country never had much gold to sell. In dumping two-thirds of its reserves, Australia put just 5.9 million ounces of gold into circulation. The U.S., by comparison, has 44 times that much gold in reserve, 262 million ounces, and law requires us

to hold on to it. Germany, Switzerland, and France, the next-largest holders of gold (95 million, 83 million, and 82 million ounces, respectively), aren't likely to destabilize the world economy by emptying their vaults either.

What I'm describing is a fairly delicate balance. Demand is healthy but price-sensitive. Supply is limited (if not in theory, then in practice) but not so limited as to drive prices up.

This is a welcoming environment for investors? Yes, I think it might be. That's because, first, the price of gold doesn't have to rise for the best mining companies to produce respectable profits. And second, if the price of gold is currently at a bottom and does eventually rise, these companies will make huge profits.

I mentioned that the average company is now spending $317 to get an ounce of gold out of the ground. Let's say you're investigating a company that's a little better than average, because of economies of scale or cheaper labor or simply because its mines yield more gold per ton of rock. Perhaps this company produces gold for 10 percent less than the average, or about $285 an ounce. Even with the price of gold limping along at $330, the company can earn good money.

There's ample proof that good companies can do well for investors even when gold itself is a bad investment. I asked Lipper Analytical Services to give me a list of all the gold mutual funds that have been around for 17 years. Seventeen years ago, of course, gold was at a peak. If you filled your dresser drawer with Krugerrands then, at $850 an ounce, you have lost 60 percent of your money. But of the seven gold funds that have been around that long, five show positive returns. The best, Franklin Gold Fund I, has gained 257 percent. The next best, Van Eck International Investors Gold Fund, is up 166 percent. Three more funds managed to stay in the black during these dark days for gold, and even the worst of them has done better than gold itself.

And what if the spot price of gold actually rises? Again it becomes clear that the best way to own gold is not to hoard Krugerrands but to own shares in the best mining companies or in the gold funds that invest in them. Let's say the spot price manages a 25 percent rally: It rises to $412.50, a little below where it was in mid-1996. Your Krugerrands are worth 25 percent more. Not bad. But the company's profits have almost tripled. Where once it cleared $45 an ounce, it now clears $127.50. When a company's profits jump like that, you can imagine what happens to the stock price--and gold stocks consistently pay modest dividends. Gold bars, obviously, don't pay anything.

I'm going to run contrary to the general pessimism and do one more exercise: Let's imagine that gold hits $500 an ounce. When it comes to investing, and especially when it comes to gold, I tend to believe that nothing is impossible, especially if it has happened before. So gold goes to $500 an ounce. If you bought your Krugerrands at $330, you've cleared 52 percent. You're a genius; maybe you should start a newsletter. Our imaginary company, however, is now clearing $215 an ounce. Profits have nearly quintupled. (This bit of leverage, by the way, explains something you'll notice when you look up gold stocks in the newspaper: They trade at extraordinarily high price-to-earnings ratios. A p/e of 50 is not considered out of line for a well-run gold- mining company at today's gold prices.)

Peter Ward, gold-mining and precious-metals analyst at Lehman Brothers, is among those people who think that gold is becoming just another commodity, that more central banks would sell if they could

only find a decent price, and that, with the possible exception of brief spikes downward, the spot price isn't likely to go much of anywhere in the next 12 months.

Nevertheless, he's excited about a couple of mining companies that have the right qualities to thrive in the current environment. His favorite is Barrick Gold (NYSE: ABX; recent price, $21.69), a Canadian firm that is the world's third-largest producer. The central fact is this: Barrick gets gold out of the ground for a cash cost (the actual cost of extraction) of $200 an ounce and a total cost of $265 an ounce. Barrick is also the industry leader in hedging: It has contracts that guarantee it a price of $420 an ounce for much of the gold it produces over the next three years.

Ward also likes Placer Dome (NYSE: PDG, $16.13), because it has some of the same qualities as Barrick. It gets gold out of the ground cheaply (a cash cost of $215 an ounce and a total cost of $280), it has a good hedging program, and it has a clean balance sheet. Victor Flores, senior mining analyst at Marleau, Lemire Securities of Toronto, thinks the long-term average spot price of gold is going to linger in a range of $350 to $385. He, too, sees good things for Barrick Gold.

Flores also likes some medium-size companies. One is Meridian Gold (NYSE: MDG, $4.25), formerly known as FMG Gold. Another is Crown Resources (Nasdaq: CRRS, $6.50), a Denver-based exploration company that is involved in a joint venture in Washington State with Battle Mountain Gold. Finally, Flores mentions a company in which I own shares, Boston-based Pioneer Group (Nasdaq: PIOG, $30.50). Pioneer is actually a money-management firm--you've probably heard of the Pioneer Family of Funds--but it also has mining interests. Among these is a 90 percent stake in Teberebie Goldfields Limited in Ghana. In Flores's opinion, Pioneer is fairly valued even without Teberebie figured in. So when you purchase Pioneer, it's like getting a $500 million gold company for almost nothing.

Let's return for a moment to Barrick Gold. In the spring of 1985, you could have picked up shares in this company for about 50 cents apiece, adjusted back for splits. Gold stood at almost exactly the same price then that it does now. By the spring of 1996, despite a miserable environment for its industry, Barrick traded at $32 a share--it had become a 64-bagger. Even if you didn't buy until 1990, and you're still holding on through a recent drop, you've tripled your money and been paid a small annual dividend for your pains.

Barrick is the kind of company that too few investors are looking for today. It has an old-fashioned business that anyone can understand. It's not the next big anything. All it does is consistently make a couple hundred million dollars a year.

No company, including Barrick, is a sure thing, of course. Say the price of gold begins to rise. The hedging contracts that are now making Barrick so profitable could become, in the short term, an albatross. If the spot price rose above the hedging price, Barrick's profits would hit a ceiling, which would suddenly make it less attractive than some rivals. But don't miss the larger point: There are great companies in just about every industry. You don't have to understand cutting-edge trends to identify these companies. You don't have to have an inside position and buy at the initial public offering. You don't even have to peg the direction of the world's most psychologically freighted commodity. You just need to keep your eyes and ears open and understand what makes a company worth owning.

Peter Lynch is vice-chairman of Fidelity Management and Research. His third investing book, Learn to Earn, was published last year by Simon & Schuster. He writes "Investor's Edge" with Dan Ferrara. Research assistance is provided by John Fried.

98/03

Best of the Best

By Peter Lynch

The question, asked of seven premier money managers: What are your favorite stocks for the near term and the long? The questioner: Well, you know him.

Now, what do you think stock pickers talk about when they get together? Other than the Red Sox, that is? Call me predictable, but when I spend time with people in my business, people whose track records I admire and whose opinions I respect, I like to kibitz about companies.

And why not? No stock picker knows so much that he can't learn a trick or a tip from a peer. Nor does a good stock picker get tired of this stuff. That's almost a matter of definition. A good stock picker is good precisely because he or she loves the process: sifting through thousands of public companies; studying balance sheets; learning the workings, the real details, of industries and businesses; investigating how a company treats its customers and vice versa. This is the only way I know to find great companies, and nothing beats the feeling when it pays off.

The peers I've been talking with recently are seven good ones. Yes, a lot of them have Boston-area connections, but that's not my attempt to plug my hometown. It simply reflects the fact that these are people I know as something more than a sketch in The Wall Street Journal and a voice on the phone. Some of these relationships, in fact, go back further than I care to admit-in one case to the mist-shrouded days of high school.

Some of the seven stock pickers you'll know by name-certainly you'll know Michael Price-and some of the others might be new to you. Among them, these seven veterans have 150 years of investment experience. All of them were on the job during the down markets of 1987 and 1990. A few were around for the long bear market that ended in 1982. The most experienced member of the group has been at it for 30-odd years and the youngest for 11.

Best of all, these people come from what's known as the buy side of the business. A lot of people tout stocks, talking about companies in newsletters and magazines or on television. These seven money managers actually go out and buy stock in the companies they recommend-thousands, even millions, of shares. This isn't an intellectual exercise-they buy shares in a market that doesn't sit still, paying commissions for the privilege and delivering good results despite these penalties.

I talked with these seven people for a couple of hours each, and it wasn't hard for them to come up with names. People at the top of this field keep a close watch on a large stable of stocks-in several cases 400 to 500. The tough part was getting down to two picks each. I asked the stock pickers to give me one recommendation for the next 12 months and another for a three- to five-year commitment. A number of them felt their picks could go either way-that the company they liked for the next year would also look fine five years out. The difference usually came down to this: The 12-month stories typically involve

a special situation, something that will bring a company back from a down period or will add a little buzz to earnings growth in the near term.

The notion of the story is an important one. As I've said so many times before, if you don't know the story, you don't know the company. (And if you don't know the company...) The level of detail here, in these 14 stories, is the minimum any investor should understand before committing money. Do you own stock in five companies? You should be able to write five stories like these. The language is pretty simple. The ideas are from the real world. It's not nearly as difficult as it is necessary.

There's an alphabetized list [on page 74 of the magazine] of the companies the pickers have picked. I suggest you start by thinking about what isn't on it. There are no technology stocks-no Microsoft, no Intel, no Cisco Systems. There are no classic cyclicals-airlines or automakers. There are only four companies in the Standard & Poor's 500 Stock Index.

I was surprised, as I talked to the stock pickers, that they weren't recommending tech stocks-there's certainly been the kind of volatility in the sector that can create buying opportunities. But then I looked more closely and understood. The stocks with good stories are fairly or highly priced in this market. The stocks that are cheap look questionable on the fundamentals. It makes sense to be cautious, because if there's an investing minefield in this decade it's the technology sector, in which so many companies catch a cold one week and are hospitalized with pneumonia the next.

As for the lack of cyclicals, it doesn't mean the stock pickers can't foresee good conditions for certain industries. But what they're most passionate about is steady earnings growth, which is not in the nature of cyclical stocks. These pros share my insistence, I think, on what I call earnings visibility, which is a way of saying we like to see those earnings coming. Which company is most certain to meet our estimates? That's the one we want to buy.

Finally, what does it suggest that only 4 of the 14 companies are in the S&P; 500? To me, it suggests opportunity. We have ten companies from a segment of the market that has struggled the past three years-the S&P;, after all, has run away from every other index since 1995. It follows that these companies may have been overlooked-which is music to a stock picker's ears.

So what does the table show?

First, it shows a breadth of companies, from all parts of the economy, whose stories any intelligent person can understand.

Second, the table shows that people are looking for value. The market, as measured by the S&P; 500, is expected to trade at a price-to-earnings ratio of 19 or 20 in 1998. Earnings are expected to grow at 10 to 11 percent, which is less than half the growth we've seen the past three years but is in line with historic performance. So the market is selling at about twice the expected growth rate. This suggests that investors are pricing stocks on the basis of unrealistic expectations about growth. Of our 14 stocks, however, 11 are selling below their expected growth rates. At the current prices for these stocks, the market is failing to take into account the real future growth of the companies. That's the essence of a good value and a good opportunity.

And now the stories. My introductions of the stock pickers are followed by their introductions, in their own words, of the stocks they believe deserve your attention.

98/06

Peter Lynch: Hope You Guess Our Name

By Peter Lynch

The markets know, or think they know, the meaning of a brand name to a company. The value of the name Coca-Cola, for example, or La-Z-Boy or even Warren Buffett is built into the price of the company's stock. But what about a brand name that hasn't been well tended? One that doesn't mean what it once did, or what it could?

In other words, what about H&R; Block?

You know what this company does: There's only one name that says "taxes" to more people than H&R; Block (nyse: hrb), and that's the name you write on your check in April. In 1997, 13.3 percent of all the individual tax returns submitted to the IRS were prepared by H&R; Block. That came to 14.3 million returns. I've owned Block shares for some time, and a big reason is its phenomenal combination of brand recognition and business reach. Who else, anywhere, has a franchise like this?

And yet, until last year, the stock mostly watched the great market rally from the sidelines. Earnings were generally lousy, and that fed into what might have been an even bigger problem: H&R; Block had begun to look like a company that didn't know where its strengths and weaknesses lay. Perception matters a lot, and most investors, if they were asked what they knew about Block, wouldn't have described the skill Block had shown in managing its core business for 43 years. They wouldn't have said that at the height of tax season Block maintained an office within ten miles of 80 percent of all Americans, or that in 1997 the company transmitted 50 percent of all returns sent to the IRS electronically, or that the value of a share of H&R; Block has increased 1,400-fold since the company went public in 1962. They would have been more likely to offer some impressions of Block's long, costly struggle to maintain its presence and investment in the new territory of online services, a struggle the company finally gave up this year when it sold its remaining stake in CompuServe to WorldCom.

There are plenty of lessons here. Memories are short. A poorly performing business can drag down a whole company. Failure attracts more attention than success. And perhaps the most important one: A brand name should be treated with the utmost care.

If H&R; Block becomes the stock some people think it can, that will be because the company now understands this. Block is in the early stages of an aggressive, far-reaching process of leveraging its brand name-- making that name mean something specific, positive, and, to a certain extent, new. Can the company pull it off? In these brand-oriented times, Block will be putting on a kind of public clinic. We all stand to learn something--and maybe earn something.

The basic fact of H&R; Block's business model is that the company takes in 80 percent of its $1.1 billion in annual revenue and more than 100 percent of its profits during tax season. In other words, Block makes money hand over fist in January, February, March, and April, and sees it dribble away the rest of the year. If it seems that H&R; Block offices pop up in your city like mushrooms and disappear the same

way, that's probably because they do. In the heart of tax season, Block operates about 8,800 offices in the U.S. After April, most of these offices shut down or at least staff down.

The basic fact of Block's brand identity is that tax preparation is the whole shooting match. That's all most people think of when they hear the name H&R; Block.

The way out of each of these boxes is the same. Block needs to develop new products and services that make sense to its loyal customers. In the U.S. alone, better than 15 million people a year sit across a desk from a Block employee (the difference between that number and the number of returns prepared by Block is that some people stop in just for filing; they pay, of course). Between two-thirds and three-quarters of each year's customers return the next year--the more complicated the tax codes and/or the customer's return, the more likely the repeat visit. This deep reach into people's lives is what distinguishes Block from nearly any other company with a well-known name--it's why I say Block isn't just a great name but one of a handful of truly great franchises in American business.

But what the company needs to do now is build wisely on the relationships it has established over the past 43 years. That has always been the sticking point. Block has made some mistakes. In particular, it has occasionally been too attracted to the idea of diversifying its business rather than exploiting its name. You might not have known that Block once owned Hyatt Legal Services, a chain of walk-in law offices. Or that it was an aggressive buyer of personnel companies, which it folded into a company called Interim Services. Those ideas are a long way from tax prep.

Then there's the CompuServe story. Block bought the company in 1980 for $23 million, then picked up a software outfit called Spry for $102 million and merged it into CompuServe. The evolution of CompuServe is not a simple story, but suffice it to say that America Online came along and ate CompuServe's lunch. CompuServe lost $186.5 million in 1997 alone. In hindsight, it seems clear that Block's expertise in tax preparation wasn't of much use when it came to a fight with AOL. Moreover, CompuServe--a big company and a highly visible one--made it difficult for investors to evaluate and value Block. Was H&R; Block a service company? A technology company? It was, in fact, an uncomfortable blend. So Block humbly unloaded its 80 percent stake in CompuServe. (The sale wasn't, by the way, the absolute disaster that some people made it out to be. WorldCom paid Block $1.1 billion in stock, which was quickly converted to cash--and add to that the $552 million Block received in 1996 when it sold 20 percent of CompuServe in an initial public offering.)

The sale of CompuServe, which was completed just a few months ago, marks a turning point for H&R; Block. The decks have been cleared. Block's balance sheet is very clean, though that's to be expected--management has traditionally been conservative. The company is now awash in cash-- about eight dollars' worth a share from the CompuServe sale and another couple dollars a share from the recent tax season. Think about what $10 a share in cash means. The stock is trading at about $47. Based on 1998 consensus earnings estimates provided by First Call, the price-to- earnings ratio is around 25, about the same as the market as a whole. But take the cash off the top and you'll see that shareholders are paying just $37 for Block's earnings. So the effective p/e on this stock is about 20, comfortably below that of the market. Given this, and the company's announcement that it will buy back up to 15 million of its own shares (out of about 105 million shares outstanding), it's no surprise that the market likes Block again. For the 12 months ended April 1, 1998, Block's stock was up 55.1 percent.

Block has a few dozen businesses, but for our purposes it can be thought of as having two sides. The first is the tax side. The second is the financial-services side.

The tax side is the cash cow and always has been. But for the past decade or more, management has been worried that the company's market might be moving toward maturity--in other words, that 13 percent of the taxpaying public is a heck of a lot and that more customers will be tough to find. What will the source of growth be?

The government, at least in part. The best thing to happen to H&R; Block's tax-prep business in years was the Taxpayer Relief Act of 1997. There was a lot of talk about tax simplification in Washington, but in the end the tax code just got more unwieldy, meaning that more Americans will have to file more-complicated returns. On top of that, many of the changes in the Taxpayer Relief Act will be phased in over several years. The door will be open at H&R; Block.

If serious tax simplification ever does come about, then, yes, Block will be vulnerable. The tax return on a postcard--that could be a company killer. So if you know something the rest of us don't about when the talk about flat taxes and national sales taxes might come to something, then you have reason to be skeptical about Block's ability to keep growing in this area. But for now, the IRS is driving ever larger numbers of taxpayers into the arms of H&R; Block.

This could fit nicely with the company's expansion plans for its core business. You think 8,800 offices is a lot? Look for more. Block will also acquire local competitors. And it will selectively acquire franchisees. For many years, the company was an aggressive franchiser (it's a cheap way of opening offices), and close to half of the offices now operate under franchise agreements, but Block thinks it will get more out of some offices if it owns them outright. Finally, Block is working hard to expand internationally. There are already more than a thousand offices in Canada, more than 300 in Australia, and a couple handfuls in the United Kingdom, the beginning of what the company hopes to make a big incursion. Block plans to move into developing countries, too, as the governments of those nations introduce their citizens to the pleasures of the income tax.

All right, but what about the threat from technology, specifically do- it-yourself tax software, which is growing in popularity? This looks like a problem for someone, but that someone probably isn't H&R; Block. Tax-return software costs up to about $50 a year for the federal version, half that much again for the state version. The average tax- preparation fee at H&R; Block is about $72. Typical Block customers, then, don't have much financial incentive to make a switch. And who's to say they don't have other kinds of incentives to stick with Block? Maybe they think that Block will provide them with expertise that will pay for itself. Maybe it's worth money to them just to avoid the time and irritation that inevitably attend doing your own taxes, computer program or not. Maybe they don't have the souped-up home computer most tax software demands. Maybe there's just a tax preparer they really like at the local Block office.

As a matter of fact, tax software is directed at the kind of individual least likely to come to H&R; Block--a person with a fairly substantial income and a fairly complex return. Block serves the middle-income customer. So the people who prefer to use tax programs are unlikely Block clients anyway. It's the independent tax preparer, the accountant doing returns for $200 to $1,000 a pop, who is likely to feel a pinch from tax software.

Besides, Block owns TaxCut, the second-most-popular tax-return program (it has a market share of about 30 percent). Sales of TaxCut increased by 150 percent in 1997. High-income people may not be walking their business into H&R; Block storefront offices, but through TaxCut, more and more of them are contributing to Block's bottom line.

And they're starting to do that in the storefronts, too. The company is expanding a division of its tax-prep business called H&R; Block Premium, which, as the name suggests, is designed to attract customers with more- challenging (and more-expensive) returns. Block now has about 600 Premium offices.

This all adds up to a plan that a lot of people think will work for Block's core business. And as I said, the market likes Block's recent direction. But let's not get too giddy about that 55 percent one-year jump in the share price: For the three years ended April 1, the compound annualized return was just 6.2 percent--pretty miserable given that the Standard & Poor's 500 Stock Index rose an annualized 32.8 percent for the period. Block's five-year annualized return was just 9.1 percent; the S&P; gained 22.4 percent. If Block is going to be a long-term growth story, the financial-services side of the business will have to pull its weight. As will the H&R; Block name.

Alexander Paris Jr., a senior investment analyst at Barrington Research Associates in Chicago, follows Block as carefully as anyone I know. With the sale of CompuServe, he points out, H&R; Block becomes not just a more profitable company but a pure play in financial services. That makes the company easier to understand, easier to value, easier to place in a portfolio. The company earned an estimated $1.50 a share in calendar year 1997. Paris expects to see a 23 percent increase (to $1.85 a share) for 1998 and another 19 percent increase (to $2.20 a share) for 1999.

Paris looks approvingly on the specifics of what he calls Block's "transition from being purely a tax-preparation business to a financial- services business." He likes, for example, the recent acquisition of Option One Mortgage. People buy houses 12 months a year--this could keep the doors of more Block offices open. Paris expects Option One, a mortgage originator with more than 5,000 mortgage brokers in 46 states, to bring in better than $100 million in revenue during Block's first year of ownership.

What will the source of growth be? The government. The IRS is driving ever larger numbers of taxpayers into the arms of H&R; Block.

Block has also begun, in a toe-in-the-water fashion, to sell financial planning out of a few offices--advice on mutual funds, annuities, IRAs, even household budgeting. Paris sees this as a logical step for the company, and he envisions Block taking it further--not just peddling advice but perhaps competing, ultimately, with the discount brokerages. Block is buying small accounting firms. And it has a referral program with Geico, the auto insurer, perhaps as a prelude to offering insurance on its own.

It's all about having enough to offer those millions of people who already take a seat before an H&R; Block employee each year, and it all makes sense. The financial lives of Americans are becoming more complex- -you'd better believe that H&R; tax customers are buying equities and mutual funds, trying to get their financial houses in order and worriedly planning for retirement.

There's one more piece to the puzzle--perhaps as important as any of the others--and that is the recent decision by Block management to really work the brand. The top decision-makers at Block have always been people with financial backgrounds, but to head up marketing, Block has brought in a whiz from Procter & Gamble, a company that knows a thing or two about branding. Don't be surprised if you find yourself one slow afternoon humming a new H&R; Block jingle.

Block has begun to attract more interest on Wall Street; Salomon Smith Barney and some other firms have officially added analyst coverage. If they haven't already, those analysts will probably begin to see what I've been seeing--that a strong H&R; Block is a heck of a takeover candidate. I'm sure you've noticed the consolidation in the financial- services industry--not just such things as the merger of Travelers Group and Citicorp but also Cendant's purchase of Jackson Hewitt, the closest thing Block has ever had to a national competitor. Think what a company gets when it picks up H&R; Block: instant dominance of the tax-prep field, a huge network of offices, all that cash, an hour of face time each spring with millions of financially active adults, and the name. Don't forget the name.

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98/10

Hidden in Plain Sight

By Peter Lynch

If I had a hammer--and I probably do, somewhere--it would have to be a Sears Craftsman. Like many, many people, I have a long history with Sears, Roebuck and Co. S I've been a Sears investor almost as long as I've been a Sears customer. I've spent more time on the phone with Harry Wren, the company's longtime head of investor relations (now retired), than with many people outside my family. I used to talk frequently with Edward Brennan, who was Sears's CEO from 1986 through 1995, and I keep current with Arthur Martinez, who succeeded Ed. I've always liked the company. Sears is a sensational brand name whose best products are sensational brands of their own--not only Craftsman but also WeatherBeater, Kenmore, DieHard, and, until it was spun off in probably the best move a Sears shareholder ever saw, Allstate. The company has always sold real things that real people need.

But to understand Sears now, you have to start over. Forget what you think you know about the company. Sears has a 112-year history and, during that time, has been an example of just about every investing lesson imaginable, but right now the one that matters is this: Sometimes it's necessary to look at familiar companies in new ways.

I have notes from a 1994 meeting with ed brennan. He talked about the corporate restructuring he had begun the previous year, and he mentioned that he had tapped a great executive for the head spot in the merchandise group. That was Arthur Martinez, who joined the company in 1992 after establishing a strong merchandising reputation at Saks Fifth Avenue. This guy is going to be dynamite, Brennan said. He and Martinez had some plans and had already begun putting them in place. Unfortunately for Sears, most analysts and money managers didn't want to listen to the story--or perhaps believe it.

When I sat down with Ed Brennan that day, Sears--at the time a $50 billion company with 360,000 employees--just wasn't running on all eight cylinders. It was still reeling from 1992, a year in which Hurricane Andrew cost Allstate $825 million (the total loss from Andrew would eventually come to about $1.65 billion) and the merchandise group lost an incredible $1.47 billion. Sears's stock gained just 2.4 percent that year, while the Standard & Poor's 500 Stock Index was rising 12.7 percent. Wall Street had decided this company was old and haggard.

Brennan's ideas fell under the heading of recognizing value. The company was so big and so diverse that it had billions of dollars' worth of assets that weren't reflected in the stock price. You might say these assets were hidden in plain sight. Brennan had begun to make some moves intended to realize their value.

Brennan and Martinez set out to redefine Sears--for Wall Street, for Sears customers, and for Sears employees. What was their goal? This will seem odd, because Sears is one of the few great retail success stories of this century, but they wanted to make Sears a retail company. How could Sears be anything other than a retail company? In 1990, 58 percent of its earnings came from Allstate--an insurance company. Dean Witter (a stock brokerage) and Coldwell Banker (a mortgage underwriter and

residential-real-estate company) accounted for another 21 percent. The merchandise group also accounted for 21 percent of earnings, but all of the company's profit came from the Sears credit card.

This wasn't a retail company; it was a crazy quilt of financial-services outfits stitched to a retail operation. Yet who on Wall Street was likely to be following this company? Retail analysts. To these folks, Sears looked unwieldy, complicated, and tired. A retail analyst forced to develop an opinion on Sears back then might very well have concluded, Hey, I'll skip this one and look at that other company--that simple, fast-growing one, Wal-Mart. The march to a new retail identity for sears, step one, 1993: Brennan shuts down the catalog operation. He kills the Big Book. It would be difficult to overstate the significance of this to the company, because Sears's corporate identity is intimately tied to the company's long history. For decades, Sears was absolutely preeminent in American business; for almost 40 years after World War II, its sales consistently represented 1 to 2 percent of the gross national product. As for the catalog, it was simply a piece of the fabric of this country. Americans regarded it as their first (and, in some parts of the U.S., only) source for everything from underwear to bathtubs, screwdrivers to guitars. It was the source for everything that made an American home and even for the homes themselves: Between 1908 and 1940, Sears sold more than 100,000 houses through the Big Book.

But in the modern era, the catalog was an increasingly iffy proposition. Here's a story I remember hearing almost 30 years ago on a vacation with my wife to Alaska: A miner sent five dollars to Sears asking for 100 rolls of toilet paper. Sears wrote back and said he'd have to order through the catalog. The miner replied that if he had the catalog he wouldn't need the toilet paper. The point: Sears spent so much money printing and distributing the catalog that it would always be a struggle to recoup the costs. So say good-bye to that bit of tradition. Say good- bye to the real-estate operation, too--Brennan sold the bulk of Coldwell Banker for roughly half a billion dollars. Then he sold 20 percent of Allstate, bringing $2.4 billion into Sears's coffers. Next to go was Dean Witer. Sears shareholders received 0.39 shares of Dean Witter for each share of Sears they owned.

Brennan's last big move was perhaps the biggest of all: He spun off Sears's remaining 80 percent share in Allstate. (Allstate had been in the Sears family since 1931.) Each share of Sears entitled the holder to 0.93 shares of Allstate; I still have mine.

I recently called Jerry Leshne, the vice president of investor relations at Sears, and asked him to help me figure out how valuable the Dean Witter and Allstate spin-offs have been for shareholders. The numbers are impressive: An investor who held $10,000 in Sears shares in 1992, and who retained the Dean Witter and Allstate shares given to him and who reinvested his dividends in all three stocks, would now have stock worth about $57,000. That's a compound annual return of 33.5 percent, compared with 20.4 percent for the S&P; 500. Or let's say you liked Sears and nothing but Sears. An investor who started with $10,000 in Sears stock in 1992, and who sold his spin-off shares upon receiving them to buy more Sears stock, would now have about $39,000 in Sears shares. That doesn't just beat the S&P.; It also beats the retail index.

The spin-offs enabled Sears to focus on retailing again. It was time for Martinez, who became CEO in mid-1995, to show why Brennan had been so high on him.

as head of the merchandise group, martinez had already begun to close inefficient stores. Now, as CEO, he continued to implement the plan he and Brennan had developed. He placed a great emphasis on remodeling stores to make them more attractive and more profitable--he redid a total of 50 million square feet and, in the process, converted 5.5 million square feet of nonproductive space to usable retail space. He developed incentive plans to re-energize employees. He worked hard on clarifying Sears's pricing policies, having learned from research that the public thought Sears's prices were all over the map. As for that hammer I may or may not own, the company decided I didn't need to have 30 options for buying another. Sears now sells a handful of different hammers rather than dozens.

These moves were all critical because Sears was in a serious fight. There was no single competitor that attempted to do everything Sears did, but add together a Wal-Mart, a Gap, a Home Depot, a Pep Boys, and a Circuit City--a combination found in plenty of communities--and you had a clear and present danger.

Sears's biggest national competitor at the time, particularly in the crucial area of soft goods (apparel, shoes, bedding, so-called home fashions, that sort of thing), was J. C. Penney. Penney, too, owned most of its stores, and it had a much better focus. The two companies were going after the same middle-income customer, and Penney was doing the better job.

Martinez was smart about taking on Penney. He set a goal for Sears of getting the same kinds of margins on soft goods that Penney was getting. He also targeted women--despite the fact that many Americans thought of Sears as primarily a place to buy tools and tires. Sears, Martinez realized, was missing the boat with women: It didn't bother with plus sizes and petite sizes in most women's apparel, for example. It didn't feel like a place that wanted female customers. As he straightened this out, Martinez put a lot of corporate energy into an ad campaign: "The softer side of Sears," which was all about making women feel more welcome. It had a great impact. Soft goods now account for 67 percent of the retail space in a Sears store, up from 58 percent four years ago. Even maternity-wear sales are up sharply.

Finally, it's time to talk about the sears brands, because with Sears functioning as a relatively straightforward retail company, these brands are the very heart of the story. I can keep this simple. WeatherBeater is the number-one exterior house paint in the country for do-it- yourselfers. Diehard is the most popular auto battery. Craftsman is the number-one line of tools. Kenmore is the number-one line of appliances.

What's more, the company has developed several good new brands. The Canyon River Blues line of jeans and other casual apparel, for example, brings in a quarter of a billion a year in revenue. And that's a heck of a lot more profitable than selling the same quantity of Lee's or Levi's. Add to that lines like Circle of Beauty (cosmetics and fragrances), Eagle Golf (golf apparel), and Fieldmaster (rugged apparel).

So Sears has a very good brand lineup. The question is how the company can make the best use of these brands in a changing retail environment.

The answer is not just the big, full-line stores--though there are 833 of those. Sears's push for the past few years has been in what it calls neighborhood stores--small, usually freestanding outlets away from the big malls. Sears now has 225 hardware stores; some are called Sears Hardware and some Orchard Supply Hardware (Sears bought the Orchard chain, which comprises 65 stores in California, in 1996).

Craftsman, not surprisingly, is king at these outlets. To sell Diehard batteries and other automotive products (including 10 percent of all the tires sold in the U.S.), Sears now operates 326 NTB (for National Tire and Battery) stores, plus 576 Parts America stores. Sears doesn't have a big name brand in furniture, but it does have 129 freestanding furniture stores, called HomeLife.

Finally, Sears has about 600 (and is shooting for 900) of what it calls dealer stores. Selling only hard goods, these stores are in small towns. The products, the look, and the prices come from Sears, but the businesses are owned (and tailored to local tastes) by local entrepreneurs. It's important and profitable to do business away from urban centers--Wal-Mart is proof of that.

There you have the retail side of Sears. But we shouldn't slight two other important sources of earnings for the company. First is the Sears credit card, which is another one of those things that remind you of the incredible depth of Sears's reach into America. Nearly half the households in the United States have a Sears card. Last year, 32 million Sears cards were used at least once.

The credit-card business has traditionally been a very good profit producer for Sears, not least because a Sears card carries a very high interest rate--generally 21 percent. But 1997 was a traumatic year for the card division. Sears had been very aggressive about getting the card into new households and, as a result, picked up a lot of bad debt. Then the company went after some of its debtors in a way that a federal court deemed too aggressive and was smacked with a huge fine. That more than ate up the division's profits for the year.

And there's also the home-services division, which may have a relatively low profile but still generates a lot of money. Sears has a network of 15,000 technicians who do everything from install air conditioners to fix dishwashers to spray for bugs to sell warranties for customers' used appliances. The market for these kinds of services is about $170 billion. Sears's piece is about $3 billion, leaving plenty of room for growth.

The new sears, then, still has a financial-services angle, but for the most part it's a great big retail company that is on good terms with just about everyone you or I know. Wall Street saw the change happening and rewarded shareholders appropriately. The stock opened 1995 at around $25 a share and closed the year at about $40. By the summer of 1997, the share price had crossed $60.

But in 1998, Sears has been in the dumps--the stock has skidded from the high $50s to the high $40s. The new freestanding stores aren't all producing, and the softer side of Sears, joked The Wall Street Journal in July, appears to be the company's earnings. The harsh truth is that yesterday's reinvention doesn't mean as much as today's execution and tomorrow's competition. Just as old companies sometimes have to learn new tricks, new companies have to keep changing. Can Sears do that?

The first thing Sears needs to square away is its credit business. Martinez says the 1997 problem was a onetime occurrence whose effects will soon have run through the system. I find that reasonable. Not all analysts believe Sears can return to the kind of credit-card profits it made as recently as 1996, but there's a broad sense that Sears's credit- card division can return to its role as a moneymaker for the company. Sears is also starting to offer its best customers better rates.

Walter Loeb, a longtime Sears analyst and president of Loeb Associates in New York, thinks the neighborhood stores will work. He also likes Martinez's next big venture: The Great Indoors. There's only one Great Indoors store so far, in Denver. With 150,000 square feet (about twice the size of the average full-line Sears), the store brings together everything Sears does relating to the interior of the American home.

Maggie Gilliam, of Gilliam & Co. in New York, is another analyst who sees Sears's greatest strength as its comprehensiveness in the area of home retailing. "Who else has a combination of appliances, furniture, credit, home improvement, and services?" she asks. "There are tons of competitors in the different sectors, but only Sears does the whole thing. Soft side as well as hard side."

But what about the matter of those soft earnings? In 1997, earnings from continuing operations fell to $2.99 a share from $3.12 the previous year. The future, fortunately, looks brighter: The consensus estimate (from First Call) for 1998 is for a 16 percent kick up to $3.46. For 1999, the estimate is for a 13 percent increase to $3.91. You don't have to pay a lot for those earnings, either: Sears trades at a price-to- earnings ratio of about 14.

Some investors dismiss old-line companies like Sears simply because they aren't fresh and exciting. That's a mistake. Let someone else take the companies with cachet; I'll settle for the ones that have valuable assets and management that knows how to use them. For the past five years, that has been a good description of Sears, which is why I'm keeping an eye on this familiar face.

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Features

99/02

Winner's Curse

By Michael Peltz

Richard Thaler lifts his wineglass, swirls its contents-a 1990 Chateau Cos d'Estournel-and takes a slow sip before setting It down next to a glass containing the 1989 vintage. An empiricist by nature, Thaler has arranged this wine tasting for fellow economists Andrei Shleifer, Kent Womack, and Luigi Zengales over dinner at a trendy Chicago restaurant on the eve of the National Bureau of Economic Research's behavioral-finance meeting. Most of the meal Is spent discussing their latest research, but at this moment, the four academics are focused on claret. "The two wines clearly come from the same vines," says Thaler, the 53-year-old Robert P. Gwinn professor of behavioral science and economics at the University of Chicago Graduate School of Business. "The more recent vintage, however, seems to have matured very quickly."

The same could be said of behavioral finance. in less than two decades, the study of how investor psychology affects markets has captured the imaginations of some of the world's finest young economic minds (Including those wine tasters, ages 35 to 42), made its way into business-school curricula, influenced the strategies of professional investors, and given conniptions to the economic old guard. Mostly this is due to Dick Thaler, the leader of the behavioral pack. Says Stanford University finance professor and Nobel Prize winner William Sharpe, "He's the one who was out there in our midst, just pushing, pushing, pushing."

In December, Thaler even began putting his money where his mouth is by offcially joining the ranks of professional money managers. He and longtime friend (and former academic) Russell Fuller hung out a shingle for Fuller & Thaler Asset Management, based in San Mateo, California. Their goal is to take advantage of quirks in investor behavior that they see as systematic-for example, the tendency of people to overreact to unexpected and dramatic news events concerning a particular stock, driving its price down too low when the news is bad and too high when it's good. The strategy of buying beaten-up stocks and avoiding high- priced glamour ones is a lot like the traditional Graham and Dodd value-Investing approach, but Thaler sees a purely behavioral rationale for why it works.

At least that's the theory. Anything can happen when theory hits the street, as Nobel economists Robert Merton and Myron Scholes learned last summer when Long-Term Capital Management, the hedge fund derived from their economic models, nearly imploded. Behaviorist Thaler observes, "It may be that they were guilty of underestimating some risks."

In the 1970s, when Thaler was writing his Ph.D. thesis in economics at the University of Rochester, there was no such thing as behavioral finance or behavioral economics. Yet he saw quirky, unexplainable economic behavior everywhere. in researching his dissertation on the economic value of a human life, he discovered that people would pay only $200 to slightly improve their odds of living yet they'd want thousands of dollars in payment to slightly increase their odds of dying. Traditional economics says that the willingness to pay and the willingness to be paid shouldn't diverge by much.

As an assistant professor at Rochester, Thaler also observed some highly curious economic behavior on the part of the faculty. Most of them chose to receive their salaries over 12 months rather than 9, even though that made far less economic sense. Then, in 1977, he met the israeli psychologists Daniel Kahneman and Amos Tversky. They introduced him to behavioral psychology and their seminal work on "prospect" theory-which in essence states that people's aversion to loss is about twice their desire for gain. in 1978, Thaler moved to Cornell University and began applying his newfound knowledge to economics.

His theories were a controversial departure from the dominant thinking of the time, led by Nobel winner Milton Friedman and other effcient-market theorists who operated out of the University of Chicago. They believed that human behavior was governed solely by the principles of rationality and self-Interest. Markets were effcient because rational investors couldn't help but drive the prices of securities toward their intrinsic value as they tried to maximize their own wealth. in a rational world, future prices were unpredictable and changed only when there was genuine news.

The heretical Thaler tended to view life and markets through a psychological prism, a throwback to economics before World War II. in the 1930s, John Maynard Keynes likened investing to the newspaper contests of his day in which competitors would be asked to pick the 6 prettiest faces from 100 photographs. "It is not a case of choosing those which, to the best of one's judgment, are really the prettiest," wrote Keynes, but "anticipating what average opinion expects the average opinion [of the prettiest to be]." Thaler thinks Keynes's beauty contest says a lot about how people should look at markets: "Good investing must combine good analysis and good psychology."

Despite the critics-University of Chicago Nobel laureate Merton Miller has deemed behavioral finance "a fad that doesn't have anything to offer"; Chicago finance professor Eugene Fama calls it "dredging for anomalies"-Thaler was gaining admirers. in 1992, he published The Winner's Curse, which, among other economic irregularities, describes the tendency to bid too aggressively in an auction as the number of competing bidders increases and why gamblers go for long shots at the end of a bad day.

Three years later, in 1995, the citadel of effcient theory itself offered him an endowed chair, despite opposition from Miller, now finance professor emeritus there. As part of the enticement, the university also offered a professorship in marketing to Thaler's fiancée, France Leclerc, who had been teaching at MIT. (They married a few months later, 35 feet underwater in HawaII.) "It speaks to the school's ecumenical views that it is willing to tolerate a guy who is not in the church," says Sherwin Rosen, Thaler's Ph.D. adviser at Rochester, who has since joined Chicago's economics department. Rosen is himself somewhat skeptical of behavioral finance but is impressed with Thaler's success. "Dick seems to be passing the market test," he says. "His stock looks very hot right now."

Acceptance into Chicago's business school was a turning point for Thaler and behavioral finance. Bright young students who came to Chicago to learn hard-core finance could now also sign up for Thaler's elective course, called Managerial Decision Making and described in the curriculum guide as "only recommended for those students who expect to have to make decisions during their careers." Thaler begins the class with an experiment that's a takeoff on some famous behavioral research: a study that found that 90 percent of Swedish drivers consider themselves better- than-average drivers-a mathematical impossibility. For his lesson, Thaler asks students to anonymously write down where they think they'll rank in the final grading. Of 125 MBA students taking this course last fall, not one thought

he or she would finish in the bottom half. "Obviously, half of them were wrong," quips Thaler. (Students typically say they'll finish in the second decile.)

These experiments speak to overconfidence, which is one of the pillars of behavioral finance. Study after study shows that people tend to overestimate their abilities and their knowledge. "We all think we are pretty good at sizing things up, just the same way we all think we are good judges of character," explains Thaler. "We should know that we really are all hopeless. When some terrible crime is committed and the neighbors are interviewed, they always say what a nice guy the alleged perpetrator was and how he couldn't have done it. The fact is, we can't tell if the guy is a serial killer or not. We also have a hard time telling a good stock from a bad one, though we think we can."

Investor overconfidence may explain what is sometimes referred to in economics as the Groucho Marx theorem. Just as Groucho wouldn't belong to any club that would have him as a member, a rational investor should be reluctant to be part of any trade where someone is willing to take the other side. After all, if the investor on the other side of the trade is also rational, he or she must have a good reason for buying or selling. According to Thaler, the Groucho Marx theorem should result in very little trading, but of course that is not the case.

Thaler's most recent paper, delivered at last October's NBER meeting, looks at asset-allocation strategies used by investors in defined- contribution retirement plans. "We discovered that many investors have incredibly naive ideas about diversification, the most extreme of which is what we call the 1/n heuristic," he says. "Basically, people tend to divide their contributions evenly among all the funds offered in their plan." Sound familiar? Although heuristics, or mental rules of thumb, are often useful in making decisions, sometimes they can be misleading, even harmful.

Eugene Fama, Thaler's friendly rival at Chicago-they play tennis together; Fama usually wins-argues that effcient-market theory actually predicts that there will be some anomalies but that they are generated by chance. "I'm willing to stipulate that investors don't always behave rationally," he says. "The issue in my mind is to what extent does irrational behavior affect pricing, and it's dIffcult to find any evidence that it does. That's what all the fighting is about."

Thaler knows he can't convert Fama, but he also understands that behavioral finance needs a mathematical theory to supplant the effcient- market hypothesis. "We're still at the stage of making fun of the geocentric model and having some theories for some facts, but we don't have a complete theory of the world," he says. "Maybe there can't be one. There certainly won't be anything as neat and tidy as the planets all circling around the sun or that everyone is rational." Thaler himself isn't likely to play a big mathematical role, but his student disciples, now teaching in business schools across America, are on the case. "Dick is more interested in the ideas than in the techniques needed to solve the problem," says Kent Womack, a former student who teaches at Dartmouth's Tuck School. "His one weakness is that he's not particularly strong in statistics or mathematics, so we do the numbers work and he thinks the big thoughts."

It might seem as if Thaler's observations couldn't find practical application within the markets, but they do. indeed, Richard Bernstein, chief quantitative strategist at Merrill Lynch, says behavioral finance is redefining the basic rules that drive the investment game. "We don't advertise it as such, but nearly everything we do in our group-our asset- allocation models, our stock-sector selection models-Is based on behavioral finance," he says. "One of the most important things in any investment strategy is to

understand the frame of reference with which people are approaching the markets, and behavioral finance helps you do that."

Thaler has every intention of taking advantage of people's frames of reference in his new money-management venture, which evolved from RJF Asset Management, a firm that had been solely owned by Fuller. "Everybody is trying to buy cheap stocks," says Thaler, who had been an adviser to RJF but is a full principal in the new firm. "In a sense, we're trying to do that, too, but we're trying to distinguish between ones that are cheap and ones that are dogs by looking explicitly for signs of systematic errors on the part of the analysts." Their firm already manages $370 million in mostly institutional assets and has five years' experience using behavioral finance. it also has a small- to mid-capitalization mutual fund, the Behavioral Growth Fund, which earned a 23 percent re- turn in its first year, and in January the firm planned to launch two new funds under the Undiscovered Managers Fund family. "Russ invests using concepts that are near and dear to my heart," says Thaler. "If I can't help improve that, there's something wrong."

Maybe that's overconfidence. Then again, maybe it's not.

Benefactor

99/06

Lost Time

By Peter Lynch

Employees may be working harder and longer than ever, but businesses are missing out on a way to improve productivity -- and benefit society

Finding money and volunteers for 13 nonprofit organizations, ranging from the Boston Inner City Scholarship Fund to the international relief organization AmeriCares, is a high priority for me these days. The money part of the equation has always been a challenge -- unglamorous and difficult. Recruiting people's time would be an easier row to hoe, or so I thought.

Volunteerism is always said to be as American as apple pie. Without it, much of what we hold dear in this country, from Little League teams to church choirs, would simply cease to exist. And many of our grandest, most important cultural and charitable organizations can attribute their success as much to the donation of brains and brawn as to the collection of gifts and grants.

But volunteerism has gone through some rocky times of late. While initiatives like the 1997 President's Summit for America's Future have helped bring about a fresh uptick in the amount of man-hours committed to charitable activities, this progress has just barely offset the losses recorded earlier this decade. In 1995, America actually had five million fewer people donating their time than it did seven years earlier.

On the positive side, the number of African-American and Hispanic volunteers has been rising. On the negative side, the number of volunteers between the ages of 18 and 24 has fallen more than 5 percent. This shortfall is being felt especially in places like New York City, where the Big Brothers/Big Sisters organization says there are 250,000 children in need, but only 2,200 active BB/BS volunteers.

Changes in our society have limited the growth of volunteerism. People have less private time available because they are spending more time at work. Not only is a greater percentage of the population employed than ever before (with the biggest increase coming in the share of women in the workforce), but many people are also working longer and more stressful hours.

Businesses have benefited from this trend, but I see little evidence that they're doing their part to offset the toll it has taken on volunteerism. A scan of the private sector turns up few examples of well-designed employee volunteer programs. The exceptions -- such as those under way at UPS, Xerox, Lucent Technologies, and Helene Curtis -- prove the rule. Chase Manhattan Bank has a terrific program called Global Days of Service. Last year, it connected more than 10,000 employees to a spectrum of volunteer activities. But are many other companies now racing to emulate this success? Sadly, no.

One has to wonder why -- especially because research about the impact of volunteerism shows it can help raise workforce productivity. One study of employees by the Independent Sector, a philanthropy research and information group, cited the following benefits: "allows me to gain a new perspective on things" (78 percent); "makes me feel needed" (68 percent); "helps me deal with some of my personal problems" (40 percent); "provides me with new contacts that help me with my business or career" (23

percent). I've personally witnessed how these types of personal experiences can translate into reduced absenteeism and office stress, as well as improved job performance. So I feel particularly befuddled when it comes to understanding why corporations don't do more -- a lot more, in fact.

In a preface I wrote for a book called Corporate Social Investing (Berrett-Koehler Publishers), I made the point that businesses could be a force in getting volunteers connected with organizations that go head-to-head with some of our toughest social problems. Experts tell us an estimated 20 billion volunteer hours were logged in 1995. When I looked more closely at these numbers, however, I was dismayed to learn that fewer than 10 percent went to organizations that offered services to the needy. In contrast, 27 percent of the total fell under the category of "informal volunteering" -- in other words, things like baby-sitting for a neighbor and baking cookies for a charitable event.

I'm certainly not suggesting that volunteerism should be restricted to the so-called core problems in our society. Bake sales have their place along with everything else. But we could see more win-win results if businesses became more serious about mobilizing volunteers for soup kitchens, homeless centers, neighborhood revitalization efforts, and so on. The neediest parts of our society would benefit even as businessmen further honed their management skills, developed more team cohesion, and improved both their individual and collective sense of self-worth.

AT&T; Wireless Services must already know this well. Managers there start many of their national meetings with a community-service project. The Gap also has an aggressive volunteer program -- one that helps connect the company with the communities in which it does business. UGI Utilities supports an Excellence in Education program that helps bring volunteers, books, and the corporation's name into schools and the community. Unitrode participates in the Salvation Army's Reach Out program, where employees and their spouses get recognized for the time they spend acting as role models for children. Programs like these don't sap corporate resources; they enhance corporate resources. Posting a list of volunteer openings on the company bulletin board won't dent any outfit's second-quarter profits. Nor will a union howl if a company invites nonprofits to hold an annual volunteer fair in the cafeteria. Want to set up an inexpensive clearinghouse to match workers with nonprofit organizations? Then do what Johnson & Johnson does: Hire some college interns, and put them to work on it.

Regardless of how, when, or where anyone chooses to donate his or her time, volunteerism is important to our country. To the extent that corporations can motivate employees to do so, they themselves will only gain in the process. And if businesses are able to channel some of this volunteer energy toward nonprofit organizations that are wrestling with society's roughest issues, then all of us -- employees, shareholders, citizens -- will benefit.

Peter Lynch is a senior contributing editor.