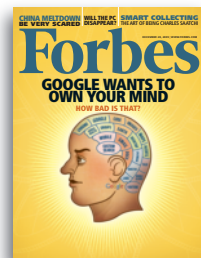


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Follow the Bonds

Peter Anderson says forget equity research and pick stocks based on how companies' bonds are performing. By Jack Gage



DON'T BELIEVE ALL THOSE earnings forecasts you get from stock analysts. You might be better off ignoring them and seeing what bond analysts have to say about a company you are interested in.

Such is the advice from Peter Anderson, a portfolio manager at Congress Asset Management, a Boston firm that oversees \$4 billion. He looks for companies whose stocks are doing comparatively

badly but whose bonds are strong. His argument is that stock analysts are slower than credit analysts to figure out that a company's fortunes have turned a corner.

As a former junk bond analyst Anderson may be viewed as somewhat biased against equity research. But he has some historical evidence. Two years ago stock prices were hitting new highs, and equity analysts were helping out with upward revisions in earnings. But prices of bonds and credit default swaps were starting to flash red (*see*

chart). Despite such signs, Anderson says, stock pickers were blind to the fact that companies with complex capital structures—banks, for example, and industrials with significant financial operations, like General Electric—posed far greater default risk than their earnings or equity values implied.

Anderson, 54, helps run \$17 million in separately managed accounts based on his bond-based Corporate Recovery Strategy. (Since its May 2005 inception, Anderson claims, it has returned 1.75% annually to the market's -0.65%.) Anderson begins by screening for companies

with the biggest divergence between stock and bond performance over a given period, usually 12 months. He plucks out companies whose stock returns rank in the bottom quintile but whose bond returns rank in the top quintile.

Among these, Anderson looks for rising interest coverage (or the multiple by which profit before interest and taxes covers interest expenses) and rising free cash flow, here defined as cash flow from operations minus capital expenditures. (Cash

flow from ops, shown after the profit-and-loss statement, is, roughly speaking, net income plus depreciation plus cash-producing changes in working capital items.)

Among the buys turned up by this analysis: Deluxe Corp., which provides design and printing services, and Conway, a freight transporter.

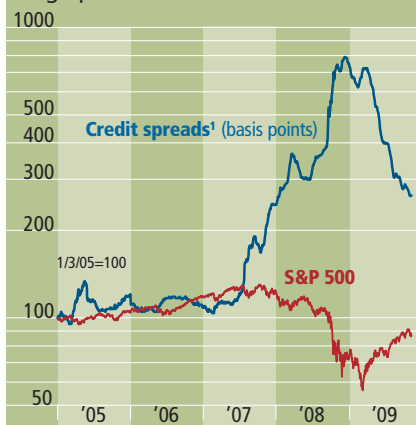
Anderson posits that as the economy sputters toward recovery, bonds will once again provide credit-conscious equity investors with early insights. If anything, he thinks, that informational edge will be bolstered by the disconnect between today's spotty fundamentals and the exuberant 60% run-up in stocks since March.

There's a subjective element to the analysis. Anderson has to like the business model. Fertilizer maker Mosaic has paid down all its debt and looks to Anderson like an acquisition candidate. He rejects Intuit, despite its statistical glow, due to weak demand for tax software.

At the end of August shares of MGM Mirage, the casino operator, had lost 70% of their value in 12 months, even as prices

LEADING INDICATOR

Credit concerns sometimes provide an early warning to stock investors. As shown below, that was the case leading up to the recent financial crisis.



¹Basis point difference between yields on investment grade corporate bonds and Treasuries with similar maturities. Sources: Merrill Lynch; FT Interactive Data via FactSet Research Systems.

of its high-yield bonds had, on average, risen 2%. Anderson liked the fact that MGM's free cash flow had improved for five straight quarters on a rolling 12-month basis—from a loss of nearly \$2 bil-

lion over the 12 months through March 2008 to a gain of \$474 million in the 12 months to June 2009. Since Sept. 1 the stock is up 38%, to the market's 10%.

Anderson owns Crown Holdings. In addition to clearing his equity-versus-credit performance hurdle, the aluminum-can maker in September bought back most of a series of senior secured bonds, after issuing unsecured debt with a higher interest rate five months earlier.

At first blush the move to a higher interest rate looked perilous. Then Anderson discovered the senior secured bonds retired forbade Crown to pay dividends. It still has issues with similar covenants outstanding, but its willingness to up its coupon and move toward paying a dividend indicated to Anderson its financials were improving and a shareholder distribution might lie ahead—something a Crown official this month confirmed.

“A company swapping one series of bonds for a more expensive one gets bond investors' attention,” says Anderson. A stock analyst he called hadn't even mentioned the debt swap to clients. **F**

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