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BARRON'S

The Dow Jones Business and Financial Weekly

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To Remember?

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September 3, 2007

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Introducing
THE

BARRON'S 400

INDEX

Using measures favored by Barron's writers,
we've helped create an index that wallops
the S&P 500 and the Dow. In essence, it picks
AMERICA'S MOST PROMISING COMPANIES.

Here's how. Page 23



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DOWJONES

Our new index of 400 companies showcases promising stocks—and trounces other measures.

Market Beater

By Michael Santoli

The Fortune 500 tots up the companies with the most revenue, a handy resource. The Forbes 400 ranks the nation's largest fortunes, an annual focus of envy and voyeurism. The Standard & Poor's 500 seeks to represent the market for the largest U.S. companies, providing an effective benchmark. ● Now, into this mix comes the *Barron's* 400, a new stock index built not as a mere reference point but as a money-making tool for investors. The *Barron's* 400 collects the most fundamentally sound and attractively priced stocks from all corners of the market, using a proven and disciplined stock-selection process. ● The index is based on the research methods of MarketGrader (www.MarketGrader.com), a Miami firm that rates stocks by a proprietary formula that incorporates companies' growth profile, profitability and stock valuation. ● As the chart on page 4 makes clear, the *Barron's* 400, using the current selection criteria, would have handily beaten standard equity indexes over the past 10 years—in bull and bear markets and in periods when large stocks dominated and when small stocks led the way. Over the past three years, when the S&P 500 index climbed by about a third, the B400, as we're calling it, surged by 54%. ● For investors, the index could be a short-cut to finding promising stocks. Through the *Barron's* 400 and related tools on *Barron's* Online, investors can track and research MarketGrader's highest-ranking stocks (see www.barrons400.com). The index is updated regularly on the Website, and its chart will appear in *Barron's*, on the The Trader column's opening page —this week, M3—with charts of the standard indexes.



The index is a twist on the idea of growth-at-a-reasonable-price, or GARP. It considers earnings growth, value, profitability and cash flow.

Barron's, of course, won't rely exclusively on the index to pick companies to write about in stories. It's worth noting, however, that the measures that this index values most are ones that *Barron's* editors and writers look at closely when evaluating companies.

Our sister unit, Dow Jones Indexes, would like eventually to license the B400 as the basis for an exchange-traded fund and other financial products.

The index encompasses stocks of all sizes, and selects among all industry sectors. *Barron's* editors, in conjunction with Dow Jones Indexes, vetted MarketGrader's approach over many months and refined the parameters of the index.

The index amounts to a twist on a growth-at-a-reasonable-price, or GARP, approach. Says MarketGrader's founder and president, Carlos Diez: "When we first started, we were trying to find a way to straddle growth and value. We thought you could have both."

After launching the research shop in 1999, he and his team spent four years refining the stock-rating process, which results in a single numerical grade for each stock, from zero to 100. The grade is generated by MarketGrader's proprietary weighting of 24 separate fundamental and stock-performance indicators, and the firm continues to tweak and perfect its process.

Here's how the index is constructed: All components of the Dow Jones Wilshire 5000—which covers nearly all investable U.S. stocks—are analyzed by MarketGrader for fundamental strength in growth, value, profitability and cash flow.

In each of those categories, a company is graded, based on six factors. To gauge growth characteristics, the MarketGrader computers consider a company's earnings—surprise record, revenue-growth rate, short- and long-term sales and earnings-growth rates and the stock's relative strength versus the market.

There's also a unique take on earnings momentum. In MarketGrader's system, this isn't about how fast earnings or earnings forecasts are rising. Rather, Diez explains, it measures the stock's reaction to the company's latest earnings report. This is an attempt at gauging the company's tendency to surprise the Street and the degree to which a stock may be unjustly neglected by analysts.

The value test involves measures of a company's capital structure (such as debt compared with equity), price-to-book ratio, price-to-cash-flow, price-to-sales, overall market capitalization and a price/earnings analysis.

The sophisticated wrinkle in the analysis is that it doesn't simply use a raw price/earnings ratio. Instead, Diez says, the system calculates each company's earnings-growth rate for the past four quarters, then comes up with an "optimum P/E ratio" for each stock. The stock's actual multiple compared with its optimal, or justifiable, P/E helps determine its value score.

Profitability is determined as a blend of asset utilization, capital utilization, operating margins, relative margins, return on equity and quality of revenues. Finally, the cash-flow ranking is derived from cash-flow growth, cash-flow margin, debt-to-cash-flow ratio, interest-coverage capacity, economic value and cash-retention rate.

These factors were selected based on their tendency to predict, in combination, the kinds of stocks that will outperform. MarketGrader won't divulge in what proportions it weights all the factors, given that it's essentially the only proprietary aspect of its own research offering, for which its customers pay at least \$100 a year.

Once all the stocks in the DJ Wilshire 5000 have their grades, they are ranked. Then a series of screens is applied. Real-estate investment trusts are eliminated. The number of entries from any one industry is capped at 20%, or 80 companies out of the 400. Any company without officially reported financials in the past six months is booted.

To ensure sufficient stock liquidity, each selection must have a minimum three-month average daily dollar-trading volume of \$2 million. The

True North

Garmin, maker of GPS navigation devices, leads the index's large-cap stocks with the best MarketGrader scores. IPC Holdings, a reinsurance concern, heads up the small-caps. Grading is on a scale of 0-100, based on growth, value, profitability and cash flow. As the lower tables show, the *Barron's* 400 draws on stocks of all sizes and in all sectors.

Company Name	Ticker	Market Value (mil)	Grade
Garmin	GRMN	\$22,617	82.1
Harley-Davidson	HOG	13,573	79.3
Halliburton	HAL	30,907	79.3
GlobalSantaFe	GSF	16,030	79.2
PepsiCo	PEP	110,859	78.9
Southern Copper	PCU	31,134	78.9
Hewlett-Packard	HPQ	129,923	78.8
Accenture	ACN	32,844	78.6
Microsoft	MSFT	270,202	78.2
Morgan Stanley	MS	65,899	77.6

Company Name	Ticker	Market Value (mil)	Grade
IPC Holdings	IPCR	\$1,531	86.3
ViroPharma	VPHM	689	85.8
Helmerich & Payne	HP	3,254	85.8
Alon USA Energy	ALJ	1,793	85.2
Chaparral Steel	CHAP	4,011	84.3
Intevac	IVAC	349	83.1
W-H Energy Services	WHQ	1,947	82.3
Sotheby's	BID	2,842	82.2
Gymboree	GYMB	1,229	81.9
optionsXpress Holdings	OXPS	1,473	81.5

Sector	Companies	Share of Index's Market Cap
Oil & Gas	78	21.16%
Basic Materials	29	7.45
Industrials	75	19.31
Consumer Goods	27	6.68
Health Care	27	6.65
Consumer Services	37	8.39
Telecommunications	1	0.31
Utilities	0	0.00
Financials	80	18.26
Technology	46	11.79
Total:	400	100.00

Size	Companies	Share of Index's Market Cap
Large-Cap	133	34.07%
Mid-Cap	75	19.19
Small-Cap	162	39.50
Micro-Cap	30	7.24
Total:	400	100.00

*Minimum \$10 bil market cap. **Maximum \$3 bil market cap.
All stocks are weighted equally, not by market value.

Sources: Dow Jones Indexes; MarketGrader.com; Bloomberg

minimum market-capitalization of all components is \$250 million, and at least 25% of the components must have a market value of at least \$3 billion.

Once all those tests are satisfied, the highest-ranking 400 stocks become the *Barron's* 400. Importantly, each stock is initially weighted equally in the index. This prevents a small minority of huge companies from steering the index. Research shows that equally weighted indexes tend to outperform market-cap weighted ones over market cycles. The B400, which was indexed to 100 as of Dec. 31, 1997, is currently at 321.04.

Every six months, on the third Friday of March and September, the whole process is rerun to incorporate more-recent financial results and market action, and the index is revised accordingly based on the fresh rankings.

Since the start of the back-testing period in 1998, the turnover rate has averaged about 40% every six months, meaning an average of 160 stocks are eliminated and another 160 are added every semester. Measured in dollars rather than component stocks, turnover of the index's total market cap has averaged closer to 30% over the decade tested. This may seem like a whopping amount of trading of components in and out for an index meant to focus on good long-term investments, but the turnover still lags behind that of the typical stock mutual fund.

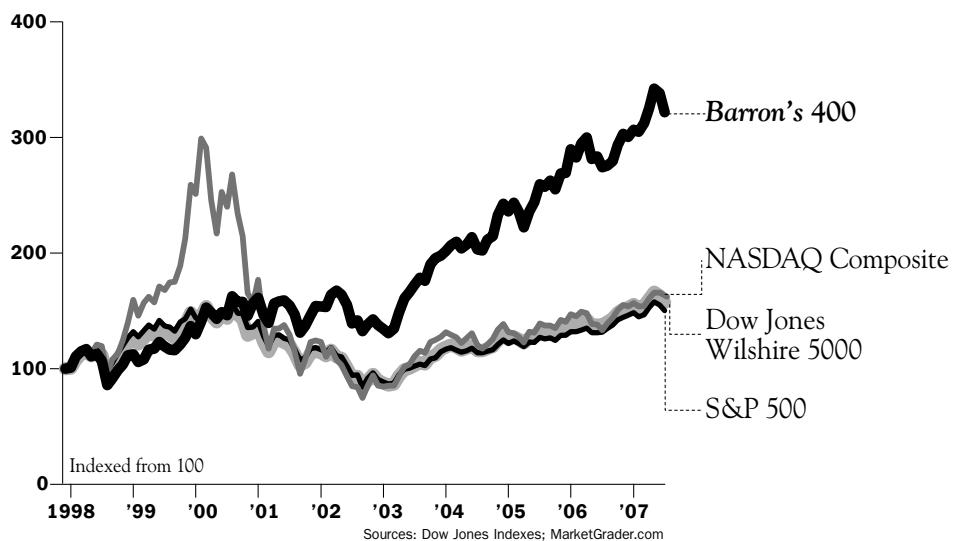
But even given this significant turnover of constituents, plenty of stocks have remained in the index for long stretches. Two—**Abercrombie & Fitch** (ticker: ANF) and **Harley-Davidson** (HOG)—have been in the index since Day One, for a nine-year run. And more than a third of the current index stocks have been in for at least five years, suggesting that this process effectively plucks from the market good long-term core holdings while also capturing stocks that may be on a temporary but lucrative upswing.

The average “holding period” of the index over the past 10 years has been just under two years.

Note that the half-yearly rebalancing process is under way, and a new list of components will emerge on Sept. 24. This will effectively upgrade the quality of the index. When the last rebalancing took place in March, the index's average MarketGrader grade was 71.5. That was just shy of the highest average score in the past decade, a reflection of the strong corporate-earnings cycle and today's sturdy balance sheets.

Going the Distance

The *Barron's* 400, based on current selection criteria, would have handily beaten the major indexes over the past 10 years. After all, it was designed explicitly as a tool for making money. Since 1998, turnover has averaged about 40% every six months, or 30% in dollar value. High, but not as high as at many mutual funds.



Sources: Dow Jones Indexes; MarketGrader.com

Now, the average grade in the B400 is 65. But note that the current average MarketGrader score for the other indexes is far lower: The Dow is at 62, the S&P 500 at 54 and the Nasdaq Composite at 42.

Among the stocks whose grades have changed significantly for the better since the current components were selected in March are **Microsoft** (MSFT), now at 78.2; **Chevron** (CVX), up to 71.5; **Frontier Oil** (FTO), 80; and **ViroPharma** (VPHM), at 85.8. On the downswing in the past six months, with low grades that suggest the stocks will be culled, are: **Mylan Laboratories** (MYL), down to 49.8; **Komag** (KOMG), at 47.4; **JAKKS Pacific** (JAKK), 44.5; and **Georgia Gulf** (GGC), at 31.

Some well-known issues that have maintained impressive grades since March include **Accenture** (ACN), **Sotheby's** (BID), **Google** (GOOG), **Hewlett-Packard** (HPQ) and **United Parcel Service** (UPS).

Which sectors are offering more, or fewer, attractive stocks? The B400 provides an indirect measure. Energy stocks, for instance, have a 21% weighting in the index B400, almost double the sector's presence in the S&P 500, which speaks to the powerful profit streak and share-price outperformance in this group.

Industrials at 19% and basic materials at 7.5% (far greater than their weight in the broad market) imply that the index is well exposed to the global-growth theme. Meanwhile, there are no utilities and only a lone telecom component, a testament

to the unfavorable growth-for-value opportunities in these two sectors that had outperformed the market coming into this year.

The index is unique in offering exposure to stocks of all sizes. As shown in the table on page 24, 47% of the index weight is in small- and micro-cap names, with 34% in large stocks and the rest in mid-caps. The 10th-largest company in the index, **Conoco Philips** (COP), is, in fact, the 20th-largest U.S.-listed company, so half the mega-caps were passed over.

Indeed, it's fair to ask whether the index's powerful outperformance over the decade is mostly a matter of riding the small-cap boom of recent years. Yet since 1998, half the upside returns of the index have come from stock with market caps of more than \$3 billion.

It should be said that the index has been undergoing a rough patch during the recent market tumult, with a loss so far in the third quarter of 6.5%, compared with 3% for the S&P 500. Many quantitative-based strategies that seek higher-quality stocks and shun riskier ones have been upended in recent weeks.

Even with this pullback, the B400 is still up 5.4% for 2007, handily ahead of the S&P 500's 2.3% and the DJ Wilshire 5000's 3%.

If history is any guide, this is the kind of outperformance investors will come to expect from the *Barron's* 400 in years to come. ■