

Seeking bargains among the thorns

Potential longer-term rewards appear to outweigh immediate risks on the stock market, suggesting investors should seize opportunities that have arisen from the selloff, DAVE EBNER writes

BY DAVE EBNER

Savage losses this month have left North American stocks mired at five-year lows. But observers are beginning to see opportunities flowering among the thorns.

"If you take a longer-term perspective, a number of bargains are emerging," said Irwin Michael, money manager at ABC Funds in Toronto. "But you need the patience of Job. Even if you buy something and it goes down, you have to stick with it."

While value exists, short-term risk abounds, underscoring Mr. Michael's message of perseverance.

Phone companies, for instance, have seen their valuations collapse in the past year. Dividend yields on big names look juicy at 4 or 5 per cent but some observers believe valuations could fall even further in the coming months, hurting stock prices. The banks also offer attractive dividends but loan losses threaten profit growth. In the materials sector, companies involved in mining, chemicals and other pursuits would benefit if the global economy recovers smartly – but the same group could suffer if the rebound fizzles.

On the whole, however, potential longer-term rewards appear to outweigh immediate risks, suggesting investors should seize opportunities that have sprung from the wasteland that is the stock market this year.

■ Telecommunication services

The phone business has obviously struggled in recent months. After the United States deregulated the industry in the mid-1990s, there was a surge of capital investment, further fuelled by the emergence of the Internet. The boom sent shares to the stratosphere, only to fall brutally when telecommunications supply overwhelmed demand.

Telecom is still seriously struggling and many companies are laden with debt. This week Moody's Investors Service Inc. cut debt of Telus Corp. cut to junk status, sending the company's stock spiralling even lower. BCE Inc. – owner of Bell Canada and The Globe and Mail – also had its debt rating cut recently, though it remains investment grade.

Valuations are down – the domestic sector trades at about 15.5 times this year's profit estimates, less than the broader market's 22.5 times. And the yields – 5 per cent on BCE and

9.8 per cent on Telus – far exceed the 2 per cent on the broad market.

But don't buy yield without some digging, said Arun Kaul, a principal at **Hillsdale Investment Management Inc.** in Toronto.

"There are questions about the sustainability of current yields – so you have to be careful," Mr. Kaul said. "If you're looking at high debt and pressure on the dividend, something's got to give."

Telus cut its dividend last year to 60 cents a share annually from \$1.40. According to analyst estimates, the company will only make 9 cents a share this year and 38 cents next year, meaning Telus would pay out more to shareholders than it actually makes. "It looks like they'll have to reduce that again," Mr. Kaul said, recommending investors avoid Telus.

On BCE, Mr. Kaul was more positive and said it appears the dividend is safe. This week company president and chief executive Michael Sabia said the \$1.20 annual dividend is "rock solid."

A more interesting investment, Mr. Kaul said, is SBC Communications Inc. of San Antonio, Tex. The company is reputed to have the best balance sheet among its peers and trades at 11.2 times trailing 12-month profits, notably cheaper than BCE's 20.4 times. SBC yields 4.1 per cent, paying a little less than half its profit to shareholders.

■ Materials

This sector features a variety of companies. In Canada, these include Alcan Inc., the world's No. 2 aluminum producer, and Barrick Gold Corp., the world's No. 2 gold miner, as well as steel makers such as Stelco Inc.

Valuations on a price-earnings basis seem high at present – the sector trades around 35 times trailing profits – but this is typical of cyclical sectors. If the economy gets rolling, analysts think Alcan can make \$3.11 a share next year, 14 times its current stock price. Alcan yields 2.2 per cent.

Recent price declines – Alcan is down 24.5 per cent this month – have "presented long-term value orientated investors with very attractive buying opportunity," Victor Lazarovici, a BMO Nesbitt Burns Inc. analyst, said this week.

"Share valuations offer unprecedented upside, led, we believe, by the nickel and aluminum

producers," Mr. Lazarovici told clients in a report. His "top picks" are nickel miner Inco Ltd., Alcan and its rival, Alcoa Inc.

Several historically reliable indicators strongly suggest the global economy is on the mend, signalling future growth that should spur demand for aluminum, steel and other basic materials. U.S. industrial production in June jumped 0.8 per cent, its sixth successive monthly gain and the biggest one-month gain since mid-1998. Meanwhile, the leading composite indicator published by the Organization for Economic Co-operation and Development has climbed eight months in a row.

Commodity prices have been driven down with stocks this month, hurt by questions of demand and the strength of the economic recovery in the United States and globally. Ernie Nutter, an analyst at RBC Dominion Securities Inc., cut his price estimates for several commodities last week – but maintained a positive outlook.

■ Financials

As recently as this spring, Canadian bank stocks were rising higher daily. There was talk that the sector was being accorded a higher valuation – around 16 times trailing profits – than it had been awarded through much of its history. Observers said the banking business was worth more because the industry has diversified its operations in the past decade. Further, the banks' loan books hadn't been stung as hard by losses as was the case in other recessions.

But then came some major bankruptcy filings, including phone company WorldCom Inc.

Toronto-Dominion Bank last week raised 2002 provisions for loan losses to \$2.1-billion from \$1.3-billion because of its exposure to the telecom and cable television industries.

The bad news, compounded by the fall in the broad market, has pushed bank valuations toward historical norms. TD trades at 14.7 times trailing profit while the industry leader, Royal Bank of Canada, trades at 14.5 times.

"Valuations more than adequately reflect credit risk," said Robert Wessel, an analyst at National Bank Financial Inc. in Toronto.

Stock-price declines have sent yields on bank stocks higher. The Big Five collectively yield about 3.5 per cent. Royal Bank, Mr. Wessel's top pick, yields 3.1 per cent.