

Bulletin 1261, December 21, 2005

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## MARKET ACTION:

With fourth quarter earnings reports still a few weeks away, the markets are left to focus on economic data for clues about future corporate performance. Several recent releases suggest that economic growth remains robust and inflation tame. Today, third quarter GDP growth was revised downward to 4.1% from the previous estimate of 4.3% in late November. Economists expect that GDP will rise 3.5% in 2005 and 3.3% in 2006; with stronger growth in the first half of '06. By any measure, this would be a solid performance for the latter stages of a recovery, but it is difficult to see how we are going to get there. Despite long-standing predictions of a slowdown, consumer spending has been growing at a 3.5%-4% clip, accounting for more than two-thirds of this year's GDP growth. With recent increases in short-term interest rates and expected slowdowns in the housing and auto sectors, many consumers will find it tough to boost spending in 2006. For that reason, most economists anticipate that businesses will pick-up the slack, using their cash stock piles to boost capital spending. Yet, equipment purchases have grown at double-digit rates for the past two years, so it is not clear just how much and for how long companies will be able to boost their spending. GDP might also get a boost from inventory rebuilding, but that is not a sustainable source of growth. Therefore, unless oil prices decline sharply, the Fed stops tightening short-term interest rates and the U.S. is able to back away from Iraq (and thereby ease some of the pressure on the budget deficit), GDP growth will probably be disappointing in 2006.

On the inflation front, the markets cheered both last week's CPI and this week's PPI reports for November, which both showed declines from October price levels following the recent drop in oil prices. At the same time, core inflation rates were well within expectations. Still, it is important to remember that core inflation rates often respond with a lag to increases in commodity prices. So even though they seem to be well behaved now, it is almost certain that core inflation rates will begin rising in the months ahead, even if energy prices stabilize at current levels. Increases in core inflation rates would prompt the Fed to continue raising interest rates, perhaps at a faster pace to slow the increase in inflation. Any increases in interest rates beyond the "neutral" level of about 4.75% would almost certainly spook the financial markets.

## ACTION THIS WEEK:

I am shifting \$20,000 from the model portfolio out of cash (i.e. T-Bills) and into GE Interest Plus Notes.

## SECURITIES COVERED IN THIS ISSUE:

	NO. OF PORT	12/20/05 SHARES PRICE	EPS 2004	PE RATIO	EPS 2005E	PE RATIO	YTD YIELD	YTD RETURN	
GE Interest Plus Notes	N/A	N/A	N/A	N/A	N/A	N/A	4.1%	N/A	
Ameriprise Financial (AMP)	300	41.57	2.80	15	2.75	15	1.1%	26.0%	
Genworth Financial (GNW)	500	33.94	2.15	16	2.40	14	0.9%	25.7%	
Time Warner (TWX)	TT	500	17.74	0.65	27	0.75	24	1.1%	-4.7%

## GE Interest Plus Notes

Although their name suggests otherwise, these notes are not issued by General Electric, but rather by its finance subsidiary, General Electric Capital Corporation. Even so, they carry a AAA-rating from the major credit rating agencies. These are variable denomination, floating rate demand notes. They can be purchased over the phone or through a special website, [www.geinterestplus.com](http://www.geinterestplus.com). You can open an account with as little as \$500. You can also link the account to your regular checking account and redeem them at any time. The interest rate on the Notes is set weekly by the GE Interest Plus Committee. The more you invest, the higher your yield. Breakpoints for the GE Interest Plus Notes are at the \$15,000 and \$50,000 levels. GECC promises that the yield will always be set at a level greater than the most recent seven-day average yield (non-compounded) for taxable U.S. money market funds, as published in the Money Fund Report ([www.imoney.net](http://www.imoney.net)). For example, the seven-day average yield on money

market funds on Dec. 20 was 3.63%, but current rates (and effective yields) on GE Interest Plus Notes are 3.80% (eff. 3.87%) for amounts up to \$15,000, 4.05% (eff. 4.13%) for amounts between \$15,000 and \$50,000 and 4.30% (eff. 4.39%) for amounts greater than \$50,000. Since these are notes and not a money market fund, there is no management fee. However, the Notes are not subject to the protection of the FDIC (as bank CD's are) or the Securities Investor Protection Corporation (SIPC). They are unsecured and unsubordinated obligations of GE Capital Corp. and rank equally with GE Capital's other unsecured and unsubordinated debt which totaled about \$323.4 billion on September 30, 2005. Perhaps about \$110 billion or so of this debt was issued by subsidiaries of GE Capital, making it structurally senior to the Notes and other unsecured debt of the holding company. In addition, nothing in the prospectus for the Notes prohibits GE Capital from issuing secured debt, which would rank ahead of the Notes. Nevertheless, I like these Notes because they are easy to understand and earn a higher yield than T-Bills or money market funds. While GE Capital is a complicated business, I like being able to look at its financial statement on a quarterly basis. In contrast, most money market funds invest in the commercial paper and notes of entities for which little or no information is available. Clearly, the higher yield means higher risk, so if you want absolute safety, you are better off investing directly in T-Bills, bank CDs or funds that invest only in direct short-term obligations of the U.S. government, such as the Schwab U.S. Treasury Money Fund (SWUXX), the Dreyfus 100% U.S. Treasury Money Market Fund (DUSXX) or the Vanguard Inflation-Protected Securities Fund (VIPSX). Still, GE Capital has a long-term record of success over all phases of the business cycle. Accordingly, I am investing \$20,000 of the model portfolio's cash in the GE Interest Plus Notes

## **Ameriprise Financial (AMP)**

In late October, Ameriprise reported third quarter adjusted net income of \$0.73 per share, up from \$0.66 last year and nine cents ahead of consensus estimates. These figures exclude the estimated \$0.24 per share in after-tax costs associated with Ameriprise's separation from its former parent, American Express, as well as the after-tax income of \$0.01 this year and \$0.11 last year attributable to AMEX Assurance, whose insurance business was ceded to American Express for a fee. Including these special items, the company reported net earnings from continuing operations of \$0.50 per share, down from \$0.77 last year. Management was pleased with the third quarter performance, saying that it reflects the successful execution of its strategies to get more of its customers to embrace financial planning, raise its profile with affluent clients and boost financial advisor productivity. Ameriprise has established the RiverSource family of mutual funds and launched a new advertising campaign to promote its new identity following its spin-off from American Express. Investors responded positively to the earnings surprise, bidding the stock up sharply from \$33.90 to a peak of nearly \$45 in early December. Since then, the stock has consolidated around the current level of \$42. Consensus estimates call for earnings of \$2.75 in 2005 and \$3.11 in 2006, which puts the valuation at about 15 times 2005 earnings and 13 times 2006 earnings, both modestly below market averages. So despite a net advance of 26% from our purchase price of \$33 in mid-October, the stock remains reasonably priced.

## **Genworth Financial (GNW)**

In late October, the company reported third quarter net operating earnings of \$0.65 per share, up from \$0.55 last year. Excluding \$0.05 per share of non-recurring earnings from bond calls, mortgage prepayments and partnerships, the company earned \$0.60, matching the consensus estimate. Operating earnings rose in all three of its business segments. Earnings in the Protection business rose 7%, due to growth in life insurance and international payment protection, which more than offset small declines in long-term care and group health and life. The Retirement Income and Investments business reported a 48% surge in operating earnings, as assets under management grew 13%. The Mortgage Insurance business saw profits rise 24%, mostly as a result of growth overseas. During the quarter, Genworth raised its quarterly dividend by 15% to \$0.075 per share. It also issued \$350 million of 10-year debt at low rates to refinance outstanding commercial paper. Over the past three months, General Electric has reduced its ownership stake in Genworth in two separate share offerings to about 18%. As a result, the company is no longer consolidated with GE. Genworth shareholders now have the right to elect all of the company's directors. In late November, Genworth was added to the S&P 500. Given the steady progress on its business objectives and its still reasonable valuation, I will continue to hold the stock.

## THE MEDIA SECTOR

Media ranks among the worst performing sectors in 2005. So far this year, the Dow Jones Broadcasting & Entertainment group - which includes stocks like Time Warner, Comcast, DirectTV and Viacom - ranks 89<sup>th</sup> out of 99 industry groups, with a decline of 11% year-to-date through December 16. This is well below the 5.9% gain for the Dow Jones Total Market Index, from which these industry groups are drawn.

This poor relative performance is due to several factors: In the film business, total box office receipts are down 5% this year and attendance is down 7%. Although movie theater operators may have finally raised ticket prices to the breaking point, declining attendance may also be the result of a weaker release calendar and cutbacks by consumers in discretionary spending. Sales of DVDs are also slowing.

At the same time, advertising spending will be probably end the year up only 4% or so. Advertisers are irked by digital video recorders, like TIVO, which allow viewers to skip commercials. Broadcasters are losing younger viewers to the internet. Although magazine advertising is up in dollar terms, the number of ad pages is down this year. Many consumers now get their news and place their classified ads on the internet for free. As a result, advertisers have shifted some of their spending away from traditional broadcasting and print media to the internet. So far this year, internet advertising, including paid search and display ads, is up 20%.

The industry also faces tough competition from the spread of technology. Cable companies are invading the turf of the regional Bell operating companies with their new digital phone services. Likewise, phone companies are threatening to supplant cable operators by installing new state-of-the-art fiber optic networks. Satellite operators, like DirecTV, continue to steal share from the cable companies and could become even more of a threat, if they team with wireless (Wi-Max) providers to offer high speed interactive (internet) services.

Finally, broadband technology now allows content producers to offer their programs directly to consumers, bypassing the cable companies and entertainment networks. Several companies, like Disney, CBS and GE's NBC Universal, have agreed to make programming available on demand through cable VOD services or internet downloads to iPods and other mobile platforms. While no viable business model using this technology has yet surfaced, it is only a matter of time before internet-based television begins to take meaningful market share from traditional distribution platforms, such as cable and broadcasting.

Thus, the media and broadcasting industry is at the threshold of significant change. Within the next decade or so, some segments of the industry may either vanish or combine with other "old-line" media. For example, local television broadcasters may combine with newspapers to offer internet-based print and video-based local news and entertainment. It is probable that these changes will take place over time, in fits and starts, driven largely by economic trends and perhaps geopolitical events. In some cases, advances may be made in a "two steps forward and one step back" manner. Throughout this period of change, content will still almost certainly be king, but we should also see fundamental changes in distribution, including the transformation of a large part of the internet to a closed system to avoid problems with viruses, spam and spyware and rationalize competition. Predicting the winners and losers in all of this, as well as the exact pace of change, may not be an easy task.

## Time Warner (TWX)

Yesterday, the company approved an agreement for Google to take a 5% equity stake in AOL for \$1 billion. The agreement also gives AOL the right to sell display advertising for Google's website along with advertising on AOL. Google has agreed to feature AOL's content prominently in its search results. Although the implied \$20 billion valuation for AOL is higher than some analysts' value estimates, Carl Icahn claims that Google's investment will make it more difficult for another potential suitor to pay more for AOL. Mr. Icahn and his hedge fund partners collectively own only a small stake in Time Warner, but they appear to be gaining clout. He has hired Bruce Wasserstein at Lazard Freres to develop a strategy for realizing the value inherent in Time Warner's businesses. Lazard should complete the analysis within the next several weeks and it is a fair bet that it will recommend some type of break-up, similar to the one recently completed by Viacom. As noted in my earlier writings, I believe that Time Warner's businesses are collectively worth much more than the company's current market value. Previously, I had ballparked its break-up value at around \$25 per share. Mr. Icahn believes that Time Warner is worth more than \$30 per share. It is difficult to know how this will eventually play out. Certainly, CEO Dick Parsons and the Time Warner board will find it difficult to resist Mr. Icahn's pressure, as long as the stock continues to languish. While the company is continuing efforts to boost its financial performance – by cutting expenses through layoffs in its publishing division, considering cutbacks in other divisions and boosting its share buyback program from \$5 billion to \$12.5 billion – it is unclear whether these efforts will make a difference. Time Warner's financial performance has pretty much matched consensus expectations so far this year, but its businesses are facing headwinds from reduced advertising spending, declining film attendance, a less promising film release schedule and fewer hit television series. A weaker performance outlook could very well add fuel to Mr. Icahn's fire. Under the company's planned acquisition of the assets of bankrupt cable-provider Adelphia Communications, which is expected to be completed by mid-year, Time Warner Cable (TWC) will become a public company after distributing 16% of its common shares to Adelphia creditors. Mr. Icahn will almost certainly press Time Warner to sell much more (if not all) of TWC to the public. He may also seek to include AOL in the spin-off, if a deal cannot be struck to sell it to another buyer. While all of this financial engineering may very well boost Time Warner's stock price next year, it is questionable whether a break-up is in the best long-term interests of the company and its shareholders. Say what you want about the AOL-Time Warner merger, I believe that the company has done a great job of responding to the challenge posed by the erosion in the dial-up business by basing the subscriber value proposition on enhanced security (i.e. virus, spam and spysweeper protection) and developing an enhanced free website to capture the growth in internet advertising. With the industry just on the threshold of rapidly expanding internet-based video content, it seems foolish that Time Warner would be forced to compromise its long-awaited plan of developing content from its world-class media properties for AOL. More importantly, while Time Warner has certainly not been the lonely torchbearer for quality entertainment, it has consistently produced many of the highest quality films and television series available. I believe Mr. Parsons when he says in response to Mr. Icahn's claims of Time Warner's bloated cost structure that you cannot take an ax to overhead in businesses whose output is driven by the creative process. Consequently, a break-up of Time Warner may hasten the slide of the media and entertainment industry toward low-budget, "reality"-driven trash.

**MARKET OUTLOOK PRESENTATION.** On Wednesday, January 11, 2006, I will give a review of the 2005 performance of the financial markets and the economy, as well as the outlook for 2006 in a conference call presentation (with slides available on the internet) starting at 7:30 PM. The call will last about one hour and include an opportunity for you to ask questions. There will be no charge to Income Builder subscribers to participate in this presentation. I will also welcome participation at no charge from potential Income Builder subscribers recommended by you. Registration will be required for this event. Sign up forms are included in this mailing. You will also be able to register for the presentation at [www.larkresearch.com](http://www.larkresearch.com) after December 21.

Bulletin 1262 will be published on Wednesday, January 5. This will be the year-end performance review, so there will be no portfolio changes. The next market update will be on the website on Wednesday, December 28 at 3:00 PM. As always, you can reach me at (732) 499-4300. Happy holidays to all of you and your families!

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