

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.

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