

96/01-Peter Lynch By Post

The stock picker's stock picker finally catches up with his mail and answers readers' questions

By Peter Lynch

Letters from readers have been piling up on my desk for more than three years. I appreciate the fact that so many of you have taken the time to ask questions and make comments. This keeps the mail carriers in shape, and I never get lonely. I'm taking this opportunity to answer a few of your questions in public.

What's your current opinion of Pier 1 Imports?

Carl J. Cooper, Rockwall, Texas

I bought Pier 1 (NYSE: PIR) for the Magellan Fund in the mid-1980s, but it was really my wife, Carolyn, who discovered it. She liked the eclectic assortment of furniture, rugs, pottery, and glassware--all imported from exotic places like Mexico and the Far East, but without the exotic prices these items would have fetched at Bloomingdale's.

In 1991, I recommended Pier 1 again after the stock had fallen to \$7 a share. The economy was in a recession, money was tight, and buying a new couch wasn't high on most people's shopping lists. Mom-and-pop furniture stores were going out of business, and big department stores were closing their home-furnishing departments. I figured as soon as the recession ended and people could afford to redecorate, Pier 1 would capture a huge chunk of a market that had been abandoned by its former competitors. Also, at the \$7 price it looked cheap.

Today, Pier 1 has 651 stores. The key element to the expansion plan is that 100 of its newest 150 outlets have opened in what the company calls "single-store markets"--places like Hattiesburg, Mississippi; Rapid City, South Dakota; and Twin Falls, Idaho. The company is expanding into smaller cities where it can attract a bigger percentage of the shoppers. These people no longer have to drive 150 miles to buy a rattan room divider.

Pier 1 has continued to cut costs and reduce debt, and it's also expanding abroad, with ten stores in the United Kingdom and outlets installed in several Sears stores in Mexico. The Mexican experiment has been a modest success, in spite of a severe recession there, and when Mexico recovers, results should improve. Although 1995 has been tough for U.S. retailers, Pier 1's domestic sales are up 11 percent. The company is likely to post record earnings of 85 cents a share for 1995. Analysts expect it to earn \$1 a share in 1996.

As I write this, the stock is selling for about \$10. Obviously, it's not as cheap as it was in 1991, but it's still undervalued at 10 times the 1996 estimated earnings, in a market where the average stock sells for 15 times earnings. Pier 1 is a mature company that is no longer growing at 20 percent a year, but it can be a decent long-term performer. I still own the stock. And every August, my two older daughters, who are away at school, furnish their rooms in Pier 1.

I enjoyed your article "Charlie Silk's 150-Bagger" in the May 1994 issue. I'm curious about what sources Charlie uses to find cash-rich companies with no debt and good earnings growth.

C.J. Biddle, La Jolla, California

That was the article in which I nominated Charlie as the world's greatest amateur investor. Figuring he ought to answer your question, I coaxed him into providing the following:

My search for undervalued Nasdaq stocks begins with Barron's, which I study every week, noting the stocks making new 12-month lows that have fallen 50 percent or more from their 12-month highs. I take this list of the downtrodden and review their fundamentals in either the Standard & Poor's monthly guide or Moody's OTC Industrial Manual. I reject the companies that have a low cash position or a declining sales trend. I'm also looking for companies whose current assets are at least two times greater than all their debt.

Whenever a company passes these hurdles, I call the investor-relations person and request the latest annual report, 10-K, proxy statement, and product literature. I study these materials to get a feel for the business, the products, and the competition. Weighing these various factors, I choose an "entry point," a price at which I would begin to accumulate the stock.

The most important factor is the cash or cash equivalents on hand. My goal is to find situations where there's little or no debt and the cash per share is nearly equal to or greater than the price of the stock. I've never seen a company with a lot of cash and not much debt go bankrupt.

A basic rule is to have the safest investment value with the smallest downside risk. The next most important consideration is the probability of a turnaround. Was this price decline a temporary aberration that can be reversed, and is there a possible re-acceleration of growth?

This approach works best at the year's end, due to tax-loss selling pressures or after a significant market decline. In a frothy market, there are very few opportunities.

Last March you wrote about Cedar Fair. Of all the hundreds of stocks available, how do you focus on a few to study and research?

Raymond Capobianco, Foster, Rhode Island

There are attractive companies everywhere: cyclicals, fast growers, slow growers, some that pay a dividend, others that don't. My theory is to stay flexible. When people limit themselves to a certain kind of company, they also limit their opportunities.

I'm always on the lookout for companies that have no debt, low price-to-earnings ratios, good records, and prospects in businesses that are easy to understand. These don't come along every day. Once I get to know a company, I look for the chance to buy more shares when the price happens to drop for reasons that have nothing to do with the fundamentals.

I discovered Cedar Fair L.P. (NYSE: FUN) in the pile of prospectuses on my desk. It had just come public in 1987, but it had owned and operated its amusement-park business for over 100 years. Here was a company that had a good growth rate and paid a dividend of 10 percent, which is rare for a solid growth company.

Later, my family and I did the on-site research, riding the roller coasters at Cedar Fair's three amusement parks in Ohio, Minnesota, and Pennsylvania. Many of the 70 million people who live within driving distance of these parks already knew this company firsthand, so they were a step ahead of me. This is another example of finding great investments close to home. None of the big Wall Street firms bothered to follow Cedar Fair, but amateur investors had the perfect chance.

The story is simple to follow. The parks are only open a few months a year, so you've got those off-season months to study the quarterly and annual reports. If the stock price drops in the idle months, you know it's not because the company has reported bad results. There are no results to report.

This is where it can pay to wait for a buying opportunity. In 1987, Cedar Fair had just come public at \$10 when the market went over the ledge. Suddenly, you could buy FUN for \$6, with an 18 percent yield. Because the market had crashed, people were worried that the country was headed into a recession. But if you did your homework, you realized that Cedar Fair's business wouldn't be affected for at least six months, because the parks had just closed.

In 1990, when the recession jitters hit the market once again, you had another opportunity to buy Cedar Fair on a dip. If you keep a list of stocks you'd like to own and watch them like a vulture, eventually you will get the chance to swoop.

Cedar Fair had a great run from its \$6 low in 1987 to its all-time high of \$36 in 1993. It's been trading between \$26 and \$36 ever since. The company also keeps raising the dividend--this year, it's \$2.30 a share.

In 1995, Cedar Fair acquired two adjoining parks outside Kansas City, Missouri. Every year, a fantastic new ride is added at one or more of the parks, the latest being the new \$12 million roller coaster in Ohio. Next year, Wild Thing will be installed in the Valleyfair park near Minneapolis. This roller coaster will be more than 200 feet tall, with a weightless zone at the crest of the second hill. I can't wait to do the research on it.

The only hitch is that Cedar Fair enjoys a favorable tax status, which is likely to run out in late 1997. But the market has already discounted that. Even if Cedar Fair paid a normal tax rate in 1996, the stock is valued at 15 times 1996 estimated earnings, so it's cheaper than the average company in the S&P 500. I own the stock.

-----In *Beating the Street* you gave Body Shop a great write-up. The stock has dropped nearly 49 percent since I bought it. What are its prospects?

William A. Boudreau Nesconset, New York

Here is another example of why investors should focus on whether the story is still valid. A stock can fall in half, only to rebound so you end up making several times your money. I'm not sure Body Shop (LON: BOS; ADR: BDSPY) will have such a rebound, but it has the potential.

The stock price tripled from a low of 125 pence (this is a British company) in 1990 to a high of 375 pence in 1992, and lately it has fallen back below 140. The earnings declined in 1993, largely because of recessions in three of the Body Shop's most mature markets: the U.K., Australia, and Canada. In 1994, the earnings made a nice recovery, but the company predicts that they will be lower for the first half of 1995. Earnings would be higher except the company is spending a lot of money to introduce new products in the U.S. and to revamp its packaging. The Body Shop faces stiff competition from The Limited's Bath & Body Works in the U.S. But whether Body Shop succeeds in the U.S. may not be that important. What's really important is what happens in the 44 other countries where it has gained a foothold.

The company could concentrate on those 44 markets alone and enjoy excellent growth for the next decade. But it has plans to open Body Shops in China, Korea, and India. This is a fast-growing global operation that is opening 150 new stores a year. Coca-Cola is in almost 200 countries worldwide, and there's no reason Body Shop can't reach the same audience.

A company that can manage to grow at 20 percent a year will double its earnings every three and a half years. The earnings quadruple every 7 years, and increase eightfold every 14 years. That's how you make big money.

That's the upside. I wouldn't take a chance on Body Shop if the company were saddled with debt. Then I'd be facing bankruptcy risk. But Body Shop is debt free. It is a profitable company, and the stock is very cheap. In my opinion, the risk/reward is favorable. I own it, and I'm sticking with it.

In October you wrote about buying shares in savings & loans. But how are the stocks of S&Ls allotted to depositors? Does the number of shares you're allowed to buy depend on how much money you have on deposit? It hardly makes sense to keep thousands of dollars on deposit for a handful of shares.

Murray Dornfeld, New York, New York

You usually have to keep at least \$50 on deposit, and sometimes the minimum can go as high as \$500, but beyond that, the size of the deposit has no effect on the allotment of shares if the S&L decides to go public. You generally can buy as many shares as anyone else.

It doesn't matter how you've deposited the money, whether it's in a checking account, a savings account, or a CD. What does matter is when you opened the account. Again, the rules vary, but people who get first dibs on the shares are usually those who've had an account with the S&L; at least a year before it announces the offering.

It's too bad 98 percent of people who have deposits in S&Ls that go public pass up the chance to research and then consider buying shares. They throw away the announcements and prospectuses they get in the mail. Don't dismiss these offers. Most of them have turned out to be great investments.