

**97/01**

## **Pain and Gain**

**By Peter Lynch**

Letters have been piling up on my desk since December 1995, the last time I devoted a column to readers. Again, I want to thank everyone who took the time to write. The volume of correspondence makes it impossible for me to respond personally to all your questions and comments, but I have chosen a few to answer here.

On your recommendation, I purchased Au Bon Pain for \$26.25 a share in January 1994. As of October 1996, the stock has fallen to six dollars. Is it worth holding, or should I sell and take the loss? Robert Schnell, Goshen, Indiana

Au Bon Pain has been a pain in the wallet -- although, if it's any comfort, I've made several recommendations over the years that were worse. The stock in this bakery-style café chain got off to a good start: from \$9 a share at the initial public offering in mid-1991 to over \$26 a year and a half later. Now it sells below the IPO price. Since I bought some for \$22.75, you and I made the same mistake. Both of us should have paid more attention to earnings, which at one point were estimated at 80 cents a share for 1994. This gave the company a price- to-earnings ratio of almost 30, which readers of this column will recognize as on the high side.

If a company manages to increase earnings at 25 to 30 percent a year, then a p/e of 30 isn't too much to pay. But here's the catch: Au Bon Pain's earnings came in at 67 cents in 1994, then disappeared into a loss of 14 cents a share in 1995. Two things went wrong: Starbucks showed up as competition, along with all its clones and a zillion bagel shops, and at the end of 1993, Au Bon Pain acquired St. Louis Bread, a chain of bakery/restaurants where the costs rose faster than the loaves.

Whenever a company does as poorly as this one has, and you own it, the first thing you want to check is its finances. Can it survive the bankers and creditors long enough to turn itself around? On that score, Au Bon Pain gets a B minus -- not great, but okay. It has borrowed \$75 million, but the balance sheet shows about \$94 million in equity. More equity than debt is comforting. So is the eight-dollar-a-share book value.

Next, you check what the company is doing to solve its problems. Au Bon Pain has been successful in downtown areas but not in suburbs, so management is concentrating on the former. Of the 281 outlets, less than 5 percent have been duds, and these are closing. The others have worked out. Whenever I go into one, it's crowded.

St. Louis Bread has been the real source of trouble because the chain grew too fast and expenses got out of control. But people seem to like these family-style restaurants, which feature fresh-baked breads. The same-store sales are growing at double-digit rates. This year, an experienced restaurant team was brought in. A new bread factory (where raw dough is made) should be up and running by the time this article hits the stands. Getting the factory on line is costly in the short term, but once the bugs are worked out, the factory has the potential to reduce costs substantially and add to earnings.

Finally, you want to ask: What's the upside here if all goes well? Au Bon Pain is adding new outlets abroad, but St. Louis Bread is the key to the company's future. If that franchise can expand from 33 restaurants to 250 or even 500, it's not hard to imagine Au Bon Pain as a very big winner. To buy this stock now, or to hold on to it, you have to believe in St. Louis Bread.

Put me in the believer camp. I still really like the dedication and skill of top management. I bought more shares in August, September, and October.

I must take exception with a few of your comments with respect to market timing. Market timing, as it is practiced by the majority of investment advisers, is a risk-management approach to investing. It enables risk-averse investors to participate in the superior returns of the stock market at a reduced risk level.

Jerry C. Wagner, Aurora, Colorado Society of Asset Allocators & Fund Timers

The only problem with market timing is getting the timing right. I haven't met many people who've done it successfully. Maybe once in a row, but not consistently. There's no telling how many timers miss big gains in stocks by making ill-timed exits. Look at the number of hedge-fund managers who've left the business since 1990.

If you had missed the 40 biggest up months on the Standard & Poor's 500 Stock Index in the past 40 years, your return from stocks would have dropped from 11.4 percent to 2.7 percent. That's how important it is to be invested in those key moments: 40 months on the sidelines out of 10,000 days of trading and you'd have been better off keeping your money in a savings account.

I've gone through this before, but let me give you another example based on actual stock-market performance from 1965 through 1995, a period with good years and bad. Imagine three investors, each of whom puts \$1,000 into stocks annually over these three decades. Investor 1, who is very unlucky, somehow manages to buy stocks on the most expensive day of each year. Investor 2, who is very lucky, buys stocks on the cheapest day of each year. Investor 3 has a system: She always buys her stocks on January 1, no matter what.

You'd think that Investor 2, having an uncanny knack for timing the market, would end up much richer than Investor 1, the unluckiest person on Wall Street, and would also outperform Investor 3. But over 30 years, the returns are surprisingly similar. Investor 1 makes 10.6 percent annually; Investor 2, 11.7 percent; and Investor 3, 11 percent. Even I am amazed that perfect timing year after year is worth only 1.1 percent more than horrible timing year after year.

The only thing that might convert me into a one-shot market timer is if the Dow suddenly rose from 6,000 to 18,000 and the market was selling for 45 to 50 times earnings, so far beyond the pale of valuation that a huge correction would be inevitable. In such an extreme case, I might wait it out in Treasury bills. But as long as stocks continue to sell in the normal range of 10 to 20 times earnings, I'm staying in.

Ask yourself this: If stock prices dropped 10 to 25 percent, would you add to your positions in stocks and mutual funds, or would you cash out and cut your losses? If the answer is that you'd cash out, then do it now and avoid the misery that is sure to come later. Stocks are a safe bet, but only if you stay invested long enough to ride out the corrections. Remember what makes them a safe bet: corporate earnings. If earnings on the S&P 500 quadruple over the next two decades, as they have in the past two, stock prices should rise at a corresponding rate.

How do you feel about bonds? Is it okay to stay with them? Worth OnLine Reader

After having written three books and numerous articles, I'm sure my feelings about bonds are hardly a secret. All things considered, I prefer stocks. People worry about the riskiness of stocks, but bonds can be just as risky. Look at what happens to the price of a bond fund the next time interest rates go up 2 percent.

If you could make the right call on interest rates five times in a row, you could buy \$10,000 worth of bond futures, roll over the profits, and become a billionaire in short order. But the ranks of interest-rate billionaires are as thin as the ranks of billionaire market timers, which tells you that interest rates are tricky to predict.

If you stick with T-bills or money-market funds, you think your money is secure, but once you pay taxes on the interest, your return might not be enough to keep up with inflation. That's how people lose money on a "safe" investment. If you buy bonds with longer maturities, you get a better interest rate, but it's fixed. This exposes you to the risk of rising rates and falling bond prices. In that situation, you can either sell the bond at a loss or wait until it matures to get back the full amount of your principal. That's why, if I bought bonds, I'd go for the intermediate maturities -- three to five years. Who wants to be stuck with a 20-year bond in a period of rising rates?

Over the past six decades, with inflation running hot and cold, long-term government bonds have earned 1.9 percent over the inflation rate, versus 7.5 percent for stocks, according to Ibbotson Associates. What is this 5.6 percent difference worth? With \$10,000 invested over 25 years, the difference becomes \$38,000.

Only once in this century have bonds had a clear advantage over stocks: during the depression of the 1930s. If you're expecting another depression, then buy Treasuries.

That said, I'm going to keep an eye on the new inflation-adjusted bonds the Treasury Department will issue in January. The return on these bonds will be pegged to the consumer price index, so if inflation heats up, bondholders will be protected. Of course, if inflation cools off, these bonds may lose their advantage, but they have the potential to be better than money-market funds.

How do you see Wal-Mart? Worth OnLine Reader

This is the colossus of retail, with \$93.6 billion in sales in 1995, more than Kmart, J. C. Penney, and Sears put together. In an average week, 60 million customers visit Wal-Mart stores; Wal-Mart takes in an annual \$360 for every man, woman, and child in America. But after 35 years of rapid growth, 27 of them as a public company, how can this hulk maintain the pace? Lately, we've seen a letup in the earnings momentum: \$1.02 a share in 1994, \$1.17 in 1995, \$1.19 in 1996.

The stock price has dropped from an all-time high of \$34.125 a share to the mid-\$20s, reflecting the slowdown in earnings and Wall Street's falling out of love with the company. Mark Husson at J. P. Morgan explains the problem of rekindling the relationship:

"I think that the growth guys look at it now and say, 'This isn't the old growth story we used to know. It's got a high-teen growth rate, below the 20 percent we once got from this company.' So the growth guys are not really interested anymore.

"If you're a value guy, you say, 'Wal-Mart is trading at a premium to its growth rate.' So the value guys aren't interested either.

"The momentum guy says, 'The chart looks awful. I'm not going to touch this.'"

Husson thinks of Wal-Mart as a proxy for retail in general, so if we have a good Christmas season in 1996, the stock might benefit. Beyond that, the company's fate is tied to the new Wal-Mart supercenters, which sell everything from appliances to groceries.

The first supercenters were rolled out in the heartland, where Wal-Mart began, but now they're moving into more densely populated areas, where the competition is tougher. The company opened 100 of these mega-sites in 1996 and plans to open another hundred or so in 1997, for a grand total of 420. It remains to be seen whether consumers will buy TVs, socket wrenches, and chicken soup under the same roof and whether Wal-Mart will get enough return on this investment to boost its profits overall.

Based on analysts' estimates for 1997, Wal-Mart will earn \$1.36 a share, giving it a p/e of 20 at the current stock price of about \$27. The company isn't the fast grower it was, but neither does it carry a fast grower's lofty price tag. If Wal-Mart can regain some of its earnings momentum, shareholders who buy at these levels can expect to be rewarded.

Do you prefer to look at a stock as a growth investment or as a source of income? Worth OnLine Reader

That depends on the stock. A stock that pays no dividend is obviously not an income investment. But in general, dividends are a more important part of the total return from stocks than people might think. According to Ibbotson Associates, the S&P 500 returned 10.6 percent annually from January 1926 to September 1996, but only if you reinvested the dividends. Remove the dividends, and these companies returned only 5.8 percent.

Today, dividends are much lower across the board than they were a few years back: 2 percent on the stocks in the S&P 500, versus 4 to 6 percent in the early 1980s. That's one reason some people are saying stocks are overpriced.

Fast-growing young companies, such as technology firms, don't generally pay dividends, which for them is a plus: They can invest in their own expansion instead of handing the money to shareholders. With slow-growing companies, a dividend becomes part of the attraction. Companies that continually raise their payout have proved to be excellent investments, but they can't prosper in the long run if the earnings aren't there.

Do you still recommend Fannie Mae? Worth OnLine Reader

Fannie Mae, the leader in the home-mortgage business, tops the list of my favorite companies of all time. I've owned it since the first Reagan administration. Lending money to home buyers is by its nature a boom-or-bust proposition, but Fannie Mae has figured out how to protect itself from the vicissitudes of interest rates.

In 1997, Wall Street analysts expect Fannie Mae to earn \$2.80 a share, whereas a decade ago, the stock sold for \$2.55 a share, adjusted for splits. That's what I call a remarkable investment: when a company's per-share earnings in a single year exceed the price you paid for the stock. No wonder the stock is up tenfold since 1987.

In spite of that incredible rise, Fannie Mae is still relatively cheap. The stock is selling at 13 times the 1997 estimated earnings, and profits are growing at 14 percent a year. On the other hand, the S&P 500 is selling at 16 to 18 times earnings, while the historic growth rate of the average company is 8 to 9 percent. So you can buy Fannie Mae at its growth rate, whereas you have to pay twice the growth rate to buy shares in the average company in today's market.

Fannie Mae is far from your average company. For ten years in a row, it has posted record earnings -- the only major financial stock in the S&P 500 ever to have done so. And the gain from the previous year has always been in double digits.

Fannie Mae isn't hurt by changes in interest rates, but a lot of people on Wall Street still worry that it will be. That's why the stock tends to drop whenever there's speculation that interest rates will rise. Another chronic worry is homeowners' defaulting on their mortgages, but Fannie Mae's delinquency rate is a negligible 0.56 percent.

A third worry surfaces from time to time: The government will ruin a good thing. Fannie Mae had its start in the depression, lending money to buyers who otherwise couldn't afford a home. Its original charter gave it a status much like a government agency, and though Fannie Mae is now a private corporation, it still is able to borrow money more cheaply than other companies. A faction in Congress periodically makes noises about altering the terms, imposing a Fannie Mae tax, or ending the relationship altogether; earlier this year, Congress held hearings on the subject.

Personally, I can't see how it would help anybody to reform Fannie Mae. The company pays more than \$1 billion a year in taxes, which makes it one of the five biggest taxpayers in the U.S. In March 1994, it announced a program to finance \$1 trillion worth of low- and moderate- income housing by the year 2000, and the program is right on track.

Ultimately, homeowners would pay the price for any change in Fannie Mae's status. As it is, the company is continuing to do good by doing well. Along with Freddie Mac, Fannie Mae is a prominent resident of the Lynch-family portfolio.

Peter Lynch writes "Investor's Edge" with John Rothchild and is vice- chairman of Fidelity Management and Research. Lynch and Rothchild's third book, Learn to Earn, was published earlier this year by Simon & Schuster.

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