

## A new strategy for picking utility stocks

Over the past 60 years, *Forecasts* subscribers have told us — many, many times — that they like utilities. The combination of a steady income stream and low stock-price volatility appeals to many investors.

However, most of today's utilities do not fit well into our investment strategy. We generally look for stocks that provide growth at a reasonable price. Historically utilities have been skimpy on the growth, and finding attractively valued utility stocks has become more difficult in the wake of the sector's four-year advance. In general, utilities tend to score poorly in our Quadrix® system, which penalizes them for low growth rates, high debt levels, low profit margins, and poor returns on equity, investment, and assets.

Only two utilities qualify for our Long-Term Buy List, and our Buy List includes none. Still, because of the sector's unique fundamentals and appeal to readers, utility stocks warrant some extra analysis.

The nature of traditional utilities, most of which operate capital-intensive plants and have returns capped by regulators, suggests that low sales and profit growth, scant profit margins, and fairly high debt levels are not necessarily signs of weakness.

Quadrix Overall scores have proven very effective at finding stocks that outperform in most sectors of the market. But while the traditional Overall score works fairly well for utilities, it works substantially better in other segments, possibly because it puts considerable emphasis on factors that are less relevant for utilities.

The Quality score (reflecting long-term growth trends and returns on equity, investment, and assets), the Performance score (stock returns), and the Financial Strength score (debt levels and profit margins) are not particularly effective for utilities. In contrast, the Value score works exceptionally well.

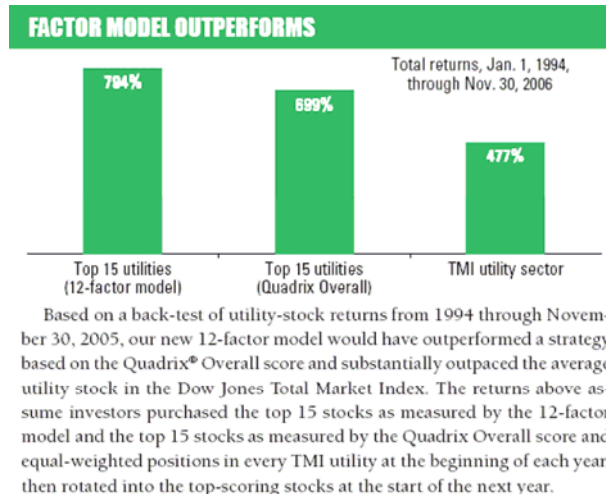
### Introducing our new 12-factor Utility Sector Model

To improve our ability to find utilities that outperform, we determined which of the more than 100 Quadrix statistics are most effective in that sector and created a scoring model using just a dozen factors. The model is heavily slanted toward value measurements, with less emphasis on balance sheet strength and long-term growth history.

Here is a breakdown of the 12 factors in the model:

- > **Valuation metrics:** Quadrix Value rank, price/book ratio, price/earnings ratio, price/book relative to three-year median, price/earnings relative to three-year median, and price/sales relative to five-year median.
- > **Momentum metrics:** Quadrix Momentum rank and six-month relative strength.
- > **Quality metrics:** three-year equity growth and long-term expected profit growth.
- > **Financial-strength metrics:** gross profit margin and EBIT margin.

Based on that 12-factor model, we calculated Utility Sector scores. Like traditional Quadrix scores, the Utility Sector score ranks utilities on a percentile basis, with 100 the best — but the sector score compares utilities only to other utilities. Subscribers can see these scores every quarter in the Utility Update, alongside the traditional Quadrix scores.



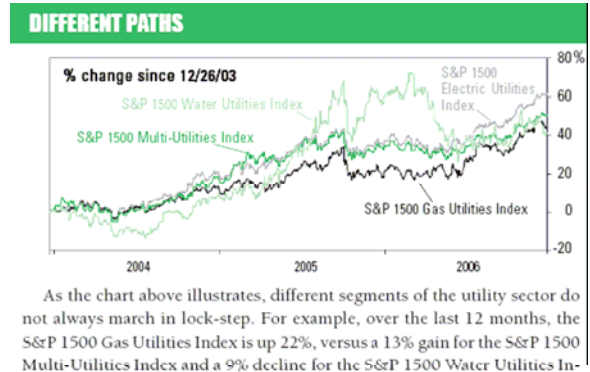
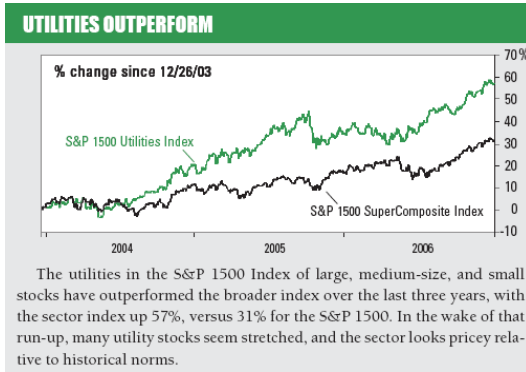
## Top 15 Utilities portfolio

In the past, the *Forecasts* has attempted to find utilities strong enough to qualify as solid investments on their own merits. Utilities rated “A” were considered good purchases. However, we have also advised subscribers to buy utility stocks in bunches, rather than concentrating the utility portion of their portfolio in one or two names. Now, we’ve made it even easier for investors to follow our advice.

Using a combination of valuation-driven Utility Sector scores, traditional Quadrix scores, and fundamental analysis, the *Forecasts* has created a Top 15 Utilities portfolio that should deliver solid total returns.

Why so many stocks in the portfolio? Here are three reasons:

- **Safety in numbers.** While utilities are still less volatile than most other stocks, individual utilities do carry some risk. One highly publicized blackout or regulatory setback can take the charge out of a utility stock. That type of bad news is very difficult to predict, and the best way to limit potential damage to your portfolio is to buy smaller positions in a larger number of stocks.
- **Industry differences.** Traditional utilities are not cyclical, but many utilities have invested heavily in such cyclical businesses as energy production and power generation. This diversification has boosted the industry’s growth potential but also made it more sensitive to economic forces. In addition, industry groups within the utility sector have drastically different characteristics, as shown in the table below, and do not move in lockstep, as illustrated by the chart labeled “Different Paths.” To guard against weakness or cyclicity in a portion of the utility market, investors should own utilities from different industry groups.
- **Overweighting.** While utilities represent just 4% of the S&P 1500 Index’s market capitalization, many income-oriented subscribers hold far larger positions in the sector. In general, the *Forecasts* recommends that investors not put more than 15% to 20% of their portfolio in utilities. A heavy concentration in any sector carries substantial risk, and anyone who plans to devote a substantial portion of a portfolio to utilities should ensure that performance does not depend too much on any individual utility.



Even investors seeking income should diversify, buying dividend-paying financials and energy stocks and sprinkling in growth stocks to increase the likelihood that the portfolio's value will rise over time.

The Top 15 portfolio, though it represents a diversified selection of utilities, is not meant to stand alone. But for investors who want to hold a slug of utilities as part of a broader mix of stocks, the Top 15 Utilities portfolio offers an appealing option.