APRIL 17, 2006

COVER STORY

Blue Chip Blues

How long will the stocks of America's largest companies remain weaklings on Wall Street?

COVER STORY PODCAST

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Just a few years ago, U.S. blue chip stocks were the most respected asset class in the world. No longer. In May, the $22 billion Fidelity Blue Chip Growth fund, which holds shares of giant U.S. companies such as Microsoft (MSFT), Johnson & Johnson (JNJ), and Wal-Mart Stores (WMT), will make a surprising request. It will ask shareholders to approve a switch in its benchmark from the Standard & Poor's 500-stock index, a traditional blue-chip barometer, to the Russell 1000 Growth Index, a broader gauge that includes many smaller companies. "The move," says fund manager John McDowell, "reflects the investment style of the fund through thick and thin." Meanwhile, another Fidelity fund, $50 billion Magellan (FMAGX), recently dumped blue chips Pfizer (PFE), Intel (INTC), and Procter & Gamble (PG) and boosted its foreign holdings to 25%, up from 4% just a few months ago.

These are confusing times for the shareholders of America's biggest corporations. General Electric Co. (GE) has boosted its earnings by 22% since Chief Executive Jeffrey R. Immelt took the reins on Sept. 7, 2001. But GE's once vaunted stock price has languished during his tenure. Home Depot Inc. (HD), the second-biggest U.S. retailer, has more than doubled its profits since 2001, a feat rewarded with a measly 1.5% bump in its stock price. Intel Corp.'s prize for boosting its earnings by 173% in five years? A 30% plunge in its shares.

A similar malaise afflicts Walt Disney (DIS), Microsoft, Pfizer, Wal-Mart, and others across many sectors and industries. What exasperates the leaders of these corporations is that it seems there's little they can do about it. They're delivering the earnings growth, but investors aren't responding. At work are forces largely beyond their control.

BOILING DOWN TO ZILCH
Welcome to the blue chip blues. The S&P 500 is near a five-year high. But don't celebrate: It has returned just 4.3% annually during that span, far less than its long-term average of 10%. The S&P 100-stock index -- the bluest of the blue chips, with $6.5 trillion in market capitalization and a huge share of U.S. corporate profits -- has returned just 2.03% annually to investors during that span, chiefly from dividends. Without dividends, it's just 0.94% overall, or 0.19% annually. In any event, after taxes and inflation, that pretty much boils down to zilch. Things have gotten so bad that ISI Group strategist Jason R. Trennert has said blue chips could be "the cheapest asset class in the developed world."

There's no law that says stock prices must track corporate earnings perfectly. But the degree of the disconnect and its long duration pose serious questions for CEOs, managers, and shareholders alike. Is this a temporary phenomenon or a permanent structural change? Should America's investor class -- the doctors and nurses, couples and singles, clerks and judges -- continue to hold these stocks as dearly as they did a few years ago? What would it take to get big U.S. stocks moving again?

Just about everything is crushing blue chips: real estate, commodities, precious metals, international stocks, and smaller U.S. stocks. And investors haven't had to be geniuses to take part in those gains. They've merely had to dust off some old ideas. Basic finance theory says that investors can get the best balance of risk and reward by owning pieces of as many of the world's asset classes as they can, from stocks to gold, alpacas to saffron. For years, the S&P 500-stock index of the biggest U.S. companies was the best approximation of that ideal available to investors -- and they flocked to it.

But in the past decade, the world's financial markets have changed in unexpected ways. The proliferation of hedge funds, those lightly regulated pools of capital that cater to wealthy investors, has allowed pension fund managers and other institutional investors to venture beyond U.S. shores and seek high returns wherever they present themselves. And the explosion of exchange-traded funds, or mutual funds that trade like stocks, has opened up the world to individual investors in ways that were never before possible. China, Mexico, and South Africa are now just a mouse click away. A decade ago, they were available chiefly through clunky, high-fee mutual funds, if at all.

With more choices, investors are diversifying their portfolios as textbooks say they should. Emerging-market shares, small U.S. stocks, gold, and even commodities are taking up sizable chunks.

ONLY GAME IN TOWN
Some market strategists think this global rebalancing act could be a 10- or 20-year process. But skeptics point out that an overseas financial crisis could erupt at any time and send investors fleeing to the relative safety of the U.S. markets -- not unlike what happened during the 1997 and 1998 Asian and Russian sell-offs.

Who's right? Before we can sort out the possibilities, we must understand how the blue chips got so popular in the first place.

The biggest U.S. stocks returned an average of 16% a year during the 1982-2000 bull market, gains that far outpaced the underlying corporate profit growth. In 1981 the average price-earnings ratio for these stocks was around 8. By 2000, at the peak of the tech bubble that sent many stocks to all-time highs, it had swelled to 35. Even a conglomerate such as GE sported a ratio nearly double its current 18. Blue chips "are coming off the biggest p-e expansion in history," says James P. O'Shaughnessy, who oversees more than $6.5 billion at Bear Stearns Asset Management Inc. (**BSC**) "In 2000 it was as if there was nothing else worth investing in."

Nothing indeed. The bull market resulted from a dearth of alternative opportunities. Long-term interest rates fell throughout the period, making bond yields less attractive to investors. Prices of oil, other commodities, and precious metals fell, too. Two housing busts soured investors on real estate by the mid-1990s. Stocks were the only game in town. The p-e ratios of companies with growing but stable earnings soared, with blue chips enjoying unprecedented popularity.

Then the profit growth stopped -- and with it, blue chip supremacy. According to Goldman, Sachs & Co. (**GS**), reported earnings per share of the companies in the S&P 500 fell from $50 in 2000 to $17.50 by 2002. The largest 100 stocks lost 53%, peak to trough. Assuming an 8% average annual return, it would still take Cisco Systems Inc. (**CSCO**) 17 years to hit its 2000 level; Microsoft, 10 years; GE, 8; and Disney, 6.

Smaller stocks have fared much better, for two reasons. For one thing, their valuations hadn't run up so much in the first place. And second, smaller companies are nimbler than big ones, and can adapt to changing economic conditions faster. As blue chip profits cratered in 2002, the earnings of the S&P 600-stock index of small capitalization companies rocketed 20%, then 15% and 28% the following two years. Investors sought out the relative value of small and midsize companies, which have returned an average of 15% and 13% a year, respectively, since March, 2001. Small caps once were considered much riskier than big ones. The big-company earnings crash showed that even the celebrated blue chips are risky, too.

The question is, which period was the aberration: 1982-2000 or 2001-06? History seems to argue for the former. According to Ibbotson Associates, small caps have returned 11.7% annually since 1926, vs. large caps' 9.8%. As Herb Stein, chairman of the Council of Economic Advisers under President Nixon, once quipped, "if something cannot go on forever, it will stop."

Hedge funds exacerbated the shift to small stocks. In 1982 they were minor players. But they took off in the late '90s and especially during this decade. Their superior information-gathering allows them to spot profit opportunities in small companies that aren't widely followed. The ability of so-called activist hedge funds to transform small companies by taking big positions and agitating for change has been another lure. Perhaps most important, hedge fund traders are trend followers, traveling in packs into and out of asset classes. Right now the trend favors small stocks. "If you were to stick a gun to my head," says Bear Stearns' O'Shaughnessy, "I'd say small caps will keep beating for 20 years."

It isn't only small caps that are dominating. Blue chips are getting crushed by just about everything overseas. South Korea was up 54% last year; Latin America, 55%; and Saudi Arabia, 108%. Russia and a resurgent Japan returned 87% and 42%, respectively. In the past five years, the S&P Citigroup Emerging Market Index has returned about 17% a year, slightly better than the annual returns U.S. blue chips posted from 1982 to 2000. Could emerging markets pull off a similar 18-year run?

Time was, investors looking for exposure to international and emerging markets would buy shares of a huge U.S. multinational, which supposedly offered transparency and sound governance and none of the crony capitalism found in emerging markets. Then the corporate scandals hit, and big U.S. companies were seen in a different light.

Nowadays, foreign pure plays are getting the benefit of the doubt over U.S. giants. For example, shares of Brazil's Banco Bradesco, which trade in the U.S. as American depositary receipts, have soared more than 370% since 2001. Citigroup's (**C**) shares have gained only 12%, despite the bank's presence not only in Brazil but also China, India, Korea, Mexico, the Philippines, Poland, Russia, and almost 100 other countries. In all, Citigroup derived 41% of its 2005 net income from foreign markets. Yet investors clearly favor the Brazilian pure play.

It's difficult to argue with the growth these nations are posting. According to statistics from the International Monetary Fund, Brazil, China, India, and Russia drove 30% of the overall growth in global demand in 2005, more than double the figure five years earlier.

And so the hunger for international stocks is huge. Since 2003, net flows to international-stock mutual funds have more than tripled, to $150 billion, while flows into U.S. funds have plunged from $154 billion to $64 billion. In January, foreign equity funds' inflows almost doubled those of December.

The explosion of lower-cost exchange-traded funds (ETFs) has only hastened the advance, making it even easier for ordinary investors to jump into and out of emerging markets. Barclays Global Investors (**BCS**) offers 37 international and global ETFs holding $72 billion in assets, up from 24 and $2 billion in January, 2001.

Some argue that emerging markets have emerged for good. "The structural story has changed," says Thomas Melendez, associate portfolio manager at MFS Emerging Markets Equity fund, which has returned an average of 38% annually for the past three years. Emerging markets, he says, will keep growing, diversifying, and cleaning up their fiscal houses.

Consider the emergence of red chips, the biggest and best companies in China. They don't have the stability of their Western counterparts, and they carry the risk of major government intervention. But over the next several years, red chips should turn bluer. Demand for the initial public offering later this year of Industrial & Commercial Bank of China, one of China's largest financial institutions, is expected to be strong. Already, Goldman Sachs has ponied up $2.58 billion for a 7% stake, ahead of a potentially $12 billion IPO that's on track to be one of the biggest ever.

Yet despite the long rally, emerging-markets companies still trade below their historical averages based on p-e and price-cash flow ratios. "The [emerging-markets] story has legs for the next 10 years," says Melendez. In fact, legendary value investor Warren Buffett, who made a fortune with big investments in blue chips such as Coca-Cola Co. (**KO**) and Gillette, recently disclosed that he had made big bets on four major stock indexes, three of which are outside the U.S.

Whether or not you share that optimism, it's clear that big U.S. stocks face much more competition for investor dollars than ever before. With nearly everything else working, why should investors bother with blue chips?

Predicting the major turning points for markets has proved perilous for investors, academics, and business publications alike. But asset classes move in discernible cycles, rising and falling over long periods of time. Commodities, for instance, ruled the 1970s, slumped for two decades, and then resurged recently.

Strategists citing the cyclical argument have been predicting a blue chip comeback for 18 months. It hasn't happened yet. "Clients gripe: 'We listened to blue chip bulls last year, and it did not work,'" says Tobias Levkovich, chief U.S. equity strategist at Citigroup. "'[The bulls are] saying the same thing this year, and it's still not working.'" The degree to which blue chips have fallen out of favor is remarkable. "When we buy a large cap, we hear: 'How can you buy that dog? It has done nothing for five years,'" says Ron Muhlenkamp, manager of the $3.2 billion Muhlenkamp Fund, which has big positions in several blue chips.

But betting against fund flows, prevailing sentiment, and trend lines has made contrarian investors rich over the years. "The time to make money," said Lord Rothschild, "is when there is blood on the streets." Big stocks are clearly wounded. "It actually hurts to say this again," wrote ISI's Trennert in a Feb. 27 research note to clients, "but we believe large caps are due."

FAT KITTY
Some of the signs that blue chips were overvalued in the 1990s are showing up in small caps now. The Russell 2000 index sports an estimated p-e of 25, a 10-point premium to the S&P 100's 15. "What ultimately wins in financial markets is valuation," says Trennert.

If valuation is king, cash is its queen. According to Moody's Investors Service (**MCO**), U.S. nonfinancial companies now hold a record $1.5 trillion of cash -- double the kitty of just seven years ago, with blue chips sitting on the most. Sooner or later, activist hedge funds will come a-calling. "The real [opportunity] is now untapped shareholder value," says Trennert. "As in: 'Give the money back -- or else.'" Attacks on a few big companies might send their stocks up. And other big-company CEOs might start spending on share buybacks, dividends, and acquisitions, to nip potential activist challenges in the bud. Dividends, of course, can be a powerful component of total return. DuPont's (**DD**) shares, for example, rose just 0.5% during the past five years. But adding and reinvesting dividends jack up the total return to 18.5%. For Microsoft, the numbers are 0.8% and 15.2%.

Rising interest rates would make those cash hoards all the more enticing. "If bond yields creep up, companies will be pressured to do more with their cash," says Marc Freed, managing director of Lyster Watson & Co., a Manhattan hedge fund-of-funds shop. Investors would no longer tolerate idle cash languishing on balance sheets if it could be put to good use.

At the same time, rising rates would hurt smaller companies, which are more dependent on short-term borrowing. So while blue chips would be spending cash in ways to benefit shareholders, small companies could see their earnings decrease as their financing costs rise. That would change the perception of small caps as can't-miss investments, and prompt a shift back to blue chips -- the long-awaited flight to quality. Trend-following hedge funds would spot the turn faster than most, pile in, and speed things up even more.

Trennert takes the argument a step further. "The single biggest reason that large caps have lagged is that the economy hasn't slowed," he says. "A slowdown would get people thinking about safe, sustainable earnings growth again."

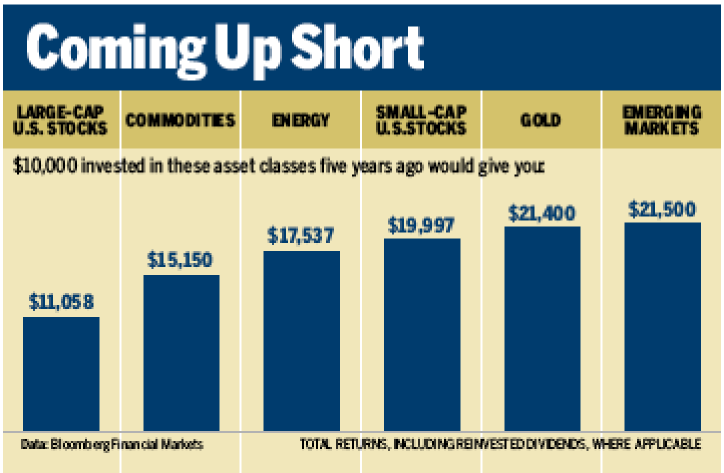
But what of the international funds and ETFs sucking so many tens of billions away from U.S. blue chips? Levkovich says the trend simply can't last. While the relative valuation of the 25 largest S&P 500 companies, including recent winners ExxonMobil (**XOM**), Hewlett-Packard (**HPQ**), and P&G, is near a 20-year low, flows into emerging-market funds as a percentage of all equity flows is twice the previous peak. The last time he saw flows so disparate was during the last call for tech and growth stocks in 2000. "You can see the fad, and know it's just a matter of time until it blows up," says Levkovich. "When people get worried, they will want the safety of U.S. equities."

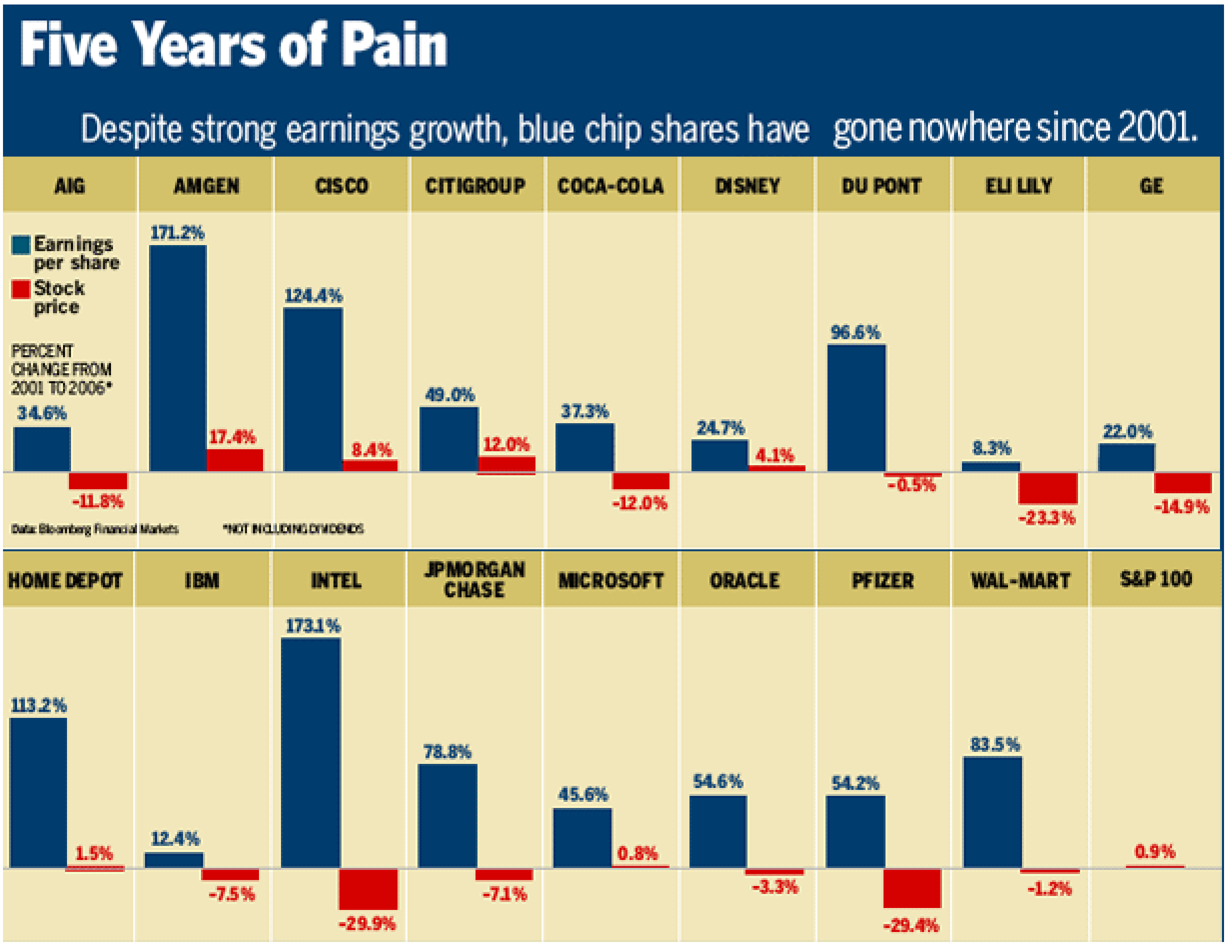
For a time, they will. But don't expect 2006 to kick off another 20-year blue chip bull market. One of the byproducts of globalization has been more efficient capital markets, with swifter and larger money flows. That poses a challenge for the millions of investors out there still fixated on big U.S. indexes. Stubbornly sticking with what used to work is a sure way to fail. "The 1990s spoiled us," says Jeffrey M. Mortimer, chief investment officer for equities at Charles Schwab Investment Management (**SCH**). "All you had to do was show up." Mortimer, who keeps his finger on the retail pulse by checking in on Schwab branches, says he's "shocked" by how hard old habits die. "They're looking east for the sunset," he says.

"The reality," says Edward Yardeni of Oak Associates Ltd., "is that we live in a much more competitive world than ever before." Big U.S. stocks will have to duke it out with red chips, small caps, gold ETFs, and all the new issues that'll hit the scene in the years to come. What's the good news? Increasingly complex financial markets mean more opportunities for investors -- and, if they're played right, fewer risks.

Bank on this: The blue chips will see another bull market, and perhaps soon. But with so many choices at investors' fingertips, the easy money may have already been made. Diversification is back. And that's not a bad thing.

By Roben Farzad




Five Years of Pain
Despite strong earnings growth, blue chip shares have gone nowhere since 2001.
Earnings per share
Stock price
PERCENT CHANGE FROM 2001 TO 2006*
AIG
34.6%
-11.8%
AMGEN
171.2%
17.4%
CISCO
124.4%
8.4%
CITIGROUP
49.0%
12.0%
COCA-COLA
37.3%
-12.0%
DISNEY
24.7%
4.1%
DU PONT
96.6%
-0.5%
ELI LILY
8.3%
-23.3%
GE
22.0%
-14.9%
Data: Bloomberg Financial Markets
*NOT INCLUDING DIVIDENDS
HOME DEPOT
113.2%
1.5%
IBM
12.4%
-7.5%
INTEL
173.1%
-29.9%
JPMORGAN CHASE
78.8%
-7.1%
MICROSOFT
45.6%
0.8%
ORACLE
54.6%
-3.3%
PFIZER
54.2%
-29.4%
WAL-MART
83.5%
-1.2%
S&P 100
0.9%


Cash, Cash, Everywhere
Corporate America* is sitting on record amounts
BILLIONS OF DOLLARS
1,600
1,200
800
400
0
'90
'91
'92
'93
'94
'95
'96
'97
'98
'99
'00
'01
'02
'03
'04
'05
Data: Moody's Investors Service
*Nonfinancial U.S. companies

GE: When Execs Outperform The Stock

When veteran recruiter Peter D. Crist tried to woo a hotshot from General Electric Co. (GE) about 18 months ago, the GE executive pressed hard about the potential upside of the stock options he would be leaving behind. Earnings were looking up. GE had expanded into cutting-edge areas such as wind power and bioscience. Innovation was the mantra and people were pumped, with some even talking about a share price that would almost double again, to 60.

With that kind of payoff on the horizon, there was little incentive for him to leave. But when Crist recently resumed discussions with the exec, his optimism about GE shares had faded. If the recruiter's client was willing simply to match the current value of the stock he owned in 2004, he would consider a move. It was the first time Crist had ever seen GE staffers view the stock as a diminished currency. In his view, "If you don't see movement by the end of this year, it could become a real issue in [staff] retention."

Within GE, two beliefs have long been held sacred: talent will be rewarded, and GE stock will make you rich. The first tenet remains as high a priority under Chief Executive Jeffrey R. Immelt as it was under his predecessor, Jack Welch. But the stock hasn't made anyone rich in years and, at less than $35, is worth less than when Immelt took the job in September, 2001.

It's a particularly sore point in a performance-driven culture like GE's. This is the place that famously culls the bottom 10% of staff and vigorously rewards its stars. More than 36,000 employees have participated in GE's stock option program, with the top tier of 180 executives having the potential to receive more than half of their pay in equity. While GE's share price hasn't prompted an exodus, it blunts a potent compensation tool and shows signs of affecting a culture long used to assuming it's the best.

The frustration is palpable in the senior ranks. At GE's annual gathering of its top brass in Boca Raton, Fla., this year, one attendee laughs that stock performance was "the unofficial theme." Then he stops himself: "I guess it's not that funny." Being a victim of broader market trends is one thing. Under-performing the Standard & Poor's 500-stock index by 7% in 2005 is quite another. "It's a bit demoralizing," he says, "especially when you're doing everything else right."

A top-level executive at another company says the prolonged price drought has dampened expectations about what it means to be GE. "A few years ago, [executives] acted like having a stock price in the 30s was a blip," he says. "Now, they're realizing the real blip was what happened in the late 1990s. Some of them may never see those highs [60] for the rest of their career."

So what's a CEO to do? Immelt starts by talking about it -- a lot. In many a public forum these days, he's first out of the gate in expressing his disappointment and frustration with the stock price. He raises it at employee town halls. He brings it up at investor meetings, even student groups. "You can tell this really grates on him," says one staffer, who received a grant of options and restricted stock about two years ago.

Efforts to boost growth and creativity are all well and good, but they have to pay off for the people who own the company. In the recent annual report, entitled "Go Big," Immelt cut to the chase. "The stock is currently trading at one of the lowest earnings multiples in a decade," he wrote. "We have good results and good governance. What will it take to move the stock?" Good question. Immelt clearly feels it's time for the market to wake up. As he pointedly writes: "We earn significantly more income and generate substantially more cash than we did when the stock traded at an all-time high."

To pump up enthusiasm, Immelt has, as he likes to say, put more skin in the game. The GE chief has been steadily beefing up his portfolio -- purchasing 30,000 shares in January for almost $1 million and buying another 15,000 shares on Mar. 13 for $502,960. That's in addition to a high-profile move in February to convert his $6 million cash bonus for 2005 into so-called performance share units. Half of the units will convert to stock if cash flow from operations grows an average of 10% or more over the next two years. The other half will convert into shares if returns at least match those of the S&P 500 during the same period. He could get almost 180,000 shares -- or nothing. "He's willing to take $6 million in pocket and put it on the line," says William J. Conaty, GE's senior vice-president of corporate human resources.

Then again, this is a man who is likely to spend at least 15 more years in the top job. (Despite the stock doldrums, his board has been behind him every step of the way.) For other executives, sitting on a static nest egg could be more of a problem. Patience can wear thin and, this being GE, senior people are often seen as ripe for plucking to lucrative executive positions elsewhere. Even if GE's stock price picks up, as it has in recent weeks, the question is whether it can compete with the potential returns offered by rivals. Crist says GE has "lots of 48-year-old guys who know they're done." Their careers won't rocket much further at GE, and their opportunities to create real wealth seem to have stalled.

Conaty acknowledges the importance of the stock in overall compensation, but says the primary motivation for GE staffers remains "challenging jobs and a career path for personal growth." Even amid the tough stock run, the company has retained 97% of its top 600 executives -- "people we really care about and don't want to lose," he notes -- and hasn't seen "any crazy spikes in turnover" lower in the ranks. Conaty says GE continues to pay strong salaries and cash bonuses to top performers.

But the company has responded to the realities that its stock might not soar as it did during the tech boom. Stock recipients now get a mix of 60% options and 40% restricted stock -- a move that Conaty attributes to lackluster stock market growth. Even in a dud market, nobody emerges completely empty-handed. The company has also doubled, to 550, the number of top executives eligible for "contingent long-term performance awards." That means lucrative bonuses if the company meets specific financial goals over a three-year period that are seen to "contribute to shareholder value." Simply getting tapped for participation in things like the stock-option program is often potent enough to keep people excited, Conaty maintains. "It's a signal from your leader that you're doing well." But everyone wants a payoff, too.

The fact that some analysts have boosted their expectations for GE's share price is some comfort to the troops right now. "It's realistic to expect it to outperform the S&P, as the fundamentals are very strong," says Ann Duignan of Bear Stearns & Co. (BSC)

Nicole Parent of Credit Suisse Group (**CSR**) is also optimistic, and understanding, arguing that "Jeff was handed a portfolio that needed a lot of strategic thought put into it." It's hard to win investor confidence when you're overhauling the portfolio and rivals like United Technologies Corp. (**UTX**) and Emerson Electric Co. (**EMR**) have posted better returns.

But A.G. Edwards & Sons Inc. (**AGE**) analyst Tony Boase perhaps best sums up the ethos of investors still waiting to see GE firing on all cylinders -- especially in the industrial businesses that account for about half of earnings. In his mind, 2006 is a critical year for proving that Immelt's rejiggered company can outperform its rivals. Investors will stay skittish, says Boase, "until the big machine really moves again." For Immelt, one key to doing that is convincing his people that the market will finally recognize their efforts.

By Diane Brady

Online Extra: Three Scenarios

VARIABLE RETURNS

PORTFOLIO 1

Portfolio Holdings	1-Yr. Return (%)	3-Yr. Return (%)	5-Yr. Return (%)
75% large caps	13.19	17.26	3.51
25% bonds	2.70	4.41	5.10
Portfolio 1 Total Return	**10.57**	**14.04**	**3.91**

PORTFOLIO 2

Portfolio Holdings	1-Yr. Return (%)	3-Yr. Return (%)	5-Yr. Return (%)
50% large cap	13.19	17.26	3.51
25% small cap	23.34	27.50	11.52
25% bonds	2.70	4.41	5.10
Portfolio 2 Total Return	**13.11**	**16.61**	**5.91**

PORTFOLIO 3

Portfolio Holdings	1-Yr. Return (%)	3-Yr. Return (%)	5-Yr. Return (%)
16.67% large cap	13.19	17.26	3.51
16.67% mid cap	20.33	24.08	8.57
16.67% small cap	23.34	27.50	11.52
25% international stocks	30.00	32.21	12.15
12.5% precious metals	63.94	37.38	36.25
12.5% bonds	2.70	4.41	5.10
Portfolio 3 Total Return	**25.31**	**24.75**	**12.14**

Portfolio analysis: 1, 3, 5 Yr. returns as of March 31, 2006 for different portfolios. Returns for each asset class is at the bottom
SOURCE: MORNINGSTAR INC.