

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Growth Investing at a Good Price



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(ZCC501) TWST: Would you start with an overview of Horizon Investment Services?

Mr. Moroney: Horizon Investment Services was started in response to a need expressed by customers of our other business, Horizon Publishing. Horizon Publishing publishes *Dow Theory Forecasts*, our flagship newsletter, and *Upside*, which focuses on small and mid-cap stocks. Subscribers expressed an interest in having us manage portfolios, partly because our newsletter portfolios had delivered strong returns. Horizon Investment Services provides separately managed accounts, mostly for individuals.

TWST: What is your investment philosophy?

Mr. Moroney: You could describe our approach as growth at a good price. We use a quantitative ranking system, Quadrix®, that scores stocks based on nearly 100 variables spread across six categories. Momentum reflects near-term operating performance. Value reflects price/earnings, price/cash flow, price/free cash flow, and other ratios, plus those ratios relative to historical norms. Quality reflects a company's long-term track record and its returns on assets, investment, and equity. Financial strength considers debt positions, interest coverage ratios, and profit margins. Earnings estimates reflect the trend in analyst estimates. Performance considers how a stock has performed over different periods over the past 12 months.

Based on scores in these six categories, stocks get an overall score of 0 to 100, with stocks scoring above 80 representing our core shopping list for new buys. To earn a good overall Quadrix score, a stock generally needs to have broad-based strength in these six categories. Some factors are more important than others, but the basic idea is to look for as many confirming factors as possible before we spend time researching a stock more closely.

Once we have screened based on Quadrix, we use individual company analysis to determine if stocks are scoring well for the right reasons. For example, are mergers inflating the results or are these bona fide numbers that suggest that stock is scoring well for valid reasons and we should look at it further? At that point, we are looking for some catalyst that suggests this stock can move over the next 12 months.

TWST: How many stocks generally do you have in your portfolio?

Mr. Moroney: Generally 35 to 50.

TWST: So it's pretty well diversified.

Mr. Moroney: Yes. The small cap accounts tend to have 35 to 40 stocks. For our Best Ideas accounts, where we are looking at companies of all sizes, we'll have 45 stocks or so.

TWST: Are you always fully invested or do you have a cash reserve?

Mr. Moroney: We will have cash reserves depending on the opportunities available in individual stocks and our view on the market's primary trend. Even if we think the primary trend is down, we are still going to be invested to a large extent. We do not engage in all-or-nothing market timing. Since 2003, we have been fairly close to fully invested.

TWST: Would you take us through your investment decision-making process and tell us what characteristics you are looking for in a potential holding?

Mr. Moroney: We employ a five-part system. First, we look for stocks that score well in Quadrix. History suggests stocks with certain attributes — such as low price/earnings ratios, positive free cash flow, and share-price momentum — tend to outperform. What we are trying to do is get a diversified blend of factors that puts the odds in our favor so that when we are looking for new stocks, we are fishing in the right pond.

Second, we investigate those companies rigorously. We consider whether results have been distorted by mergers or aggressive accounting, whether earnings and cash flow are telling a similar story, or any red flag that suggests Quadrix isn't telling the full story.

Third, we examine company and industry prospects, trying to look forward. Quadrix tends to be somewhat backward-looking, like all ranking systems. So we want to have an understanding of company prospects, which can help put the Quadrix scores in perspective. We generally avoid companies with the most uncertain outlooks. We steer clear of the most controversial stocks, instead emphasizing stocks with good operating momentum and attractive valuations. But, we are generally not looking for the cheapest stocks or the very best earnings performance from the last quarter. We are looking for companies in the sweet spot of growth at a good price.

Fourth, we reconsider valuation. Valuations are a big part of Quadrix, but we want to be doubly sure that the bright picture painted by Quadrix and other indicators is not already reflected in the stock's price.

Fifth, we look for a catalyst. What is it we think this stock has that's better than other stocks that also score well in Quadrix? What is it about this company's position that could drive superior returns over the next 12 months?

I would say the one thing that has really helped us is relentlessly searching for those 40 to 45 best ideas — not being satisfied with stocks just because they are doing okay or just because they've been good stocks or good companies. In our view, if a stock is not a buy, it's a sell.

TWST: Are you finding enough opportunities at this time? What is the investment lineup like for your type of investing?

Mr. Moroney: So far this year, it has been very favorable. A growth-at-good-price approach has worked fairly well, and some of the industry exposures we've emphasized have worked quite well for us. Energy has worked well again. That's a group that continues to score very well in Quadrix. Some of our specialty finance names also have done very well for us. I think our stock-by-stock approach will continue to work well in this market. The major averages have not

been surging higher. But, beneath the surface, you still have a broad market that's mostly advancing, and there are still enough quality stocks at good prices to keep your money at work in the stock market.

TWST: What has your performance record been for the small cap and the Best Ideas? Do you have benchmarks that come out of the portfolio?

Mr. Moroney: Since the Best Ideas portfolio began July 31, 2003, the portfolio is up 74.1% net of fees through March 31. The benchmark we use — a 50-50 blend of the Russell 2000 and Russell 1000 — is up 52.8%. Over the same period, the S&P 500 is up 37.2%.

Our small cap strategy, called the Upside Plus portfolio, began November 28, 2003. Through March 31, the portfolio is up 66.1% net of fees since inception, versus 43.8% for the Russell 2000.

TWST: Would you tell us about some of your holdings that you feel are representative of your investment approach, and the reasons why you were attracted to them?

Mr. Moroney: Energy is a group that ranks very well in our quantitative work, and one energy stock I like quite a bit is **Helix Energy (HELX)**. The company is a hybrid, with about one-half of its business in oilfield services, where it is benefiting from a very positive industry environment. The other half of the company is exploration and production. Recently, **Helix** agreed to buy **Remington Oil and Gas (REM)**, which Wall Street wasn't overjoyed about. Investors are concerned that **Helix** is becoming an exploration and production company, and p/e ratios for that group tend to be lower. But when you look at the earning power of this company, the growth likely this year and beyond, and the strong cash flow, Wall Street's concern seems to have presented a compelling buying opportunity.

1-Year Daily Chart of Helix Energy



Chart provided by www.BigCharts.com

Another one I like quite a bit is **Merrill Lynch (MER)**. The company is benefiting from a strong industry environment and is doing a lot of the right things in terms of streamlining and focusing on what it does best. **Merrill** is still reasonably valued and still scores well in our ranking system.

Another area where we have done well is the industrials, where Quadrix did a good job of pointing out that industrial companies were posting strong results and yet the stocks were pretty cheap. The group has had a pretty good run. A company like **Ingersoll-Rand** (IR), selling at about 14 times expected earnings and growing earnings at a double-digit rate, is a stock that I would characterize as being in the sweet spot with the potential to exceed expectations.

TWST: Do you like technology stocks?

Mr. Moroney: We do have technology. I would say it is an area where you want to be selective. I don't think an investment in a technology index fund would be particularly attractive, but I do think there are attractive areas. **Komag** (KOMG) is a stock we like. The company is benefiting from a strong environment for disk drives. **Komag** makes thin-film media incorporated into disk drives. The disk-drive companies are doing fairly well right now, and **Komag** has been able to raise prices and grow volumes at the same time. Wall Street is skeptical that this can continue, so the stock sells at about 9 times this year's expected earnings.

Another technology company we like is **Harris** (HRS). The company's defense business has been driving the stock over the past six months. **Harris** produces communications equipment, including advanced walkie-talkies and other products for the US military. **Harris** also has a commercial business that provides technology for broadcasters. If the company can sustain its momentum in defense and get going on the commercial side, **Harris** should be able to pleasantly surprise Wall Street going forward.

1-Year Daily Chart of Harris



Chart provided by www.BigCharts.com

TWST: What is the selling process? What triggers an exit from your portfolio?

Mr. Moroney: Several things will trigger a sell. Quadrix is useful for pointing out potential sells because every week you see how a stock is scoring. If a stock's score is drifting down, it forces us to take another look and consider whether we would buy the stock today. So number one would be deteriorating Quadrix scores.

Number two would be a valuation that seems to discount a best-case scenario already. With small stocks especially, we want to sell when the news is still good. When the news turns bad, especially with smaller companies, you can get hurt in the rush to the exits. So if we think a story is already played out and a stock will be hard-pressed to command a higher p/e or a higher price/cash flow ratio, we will sell and get our money into a better idea.

Finally, we'll sell if a company disappoints in a material way. We are not going to sell just because earnings were a penny below expectations. But if a company disappoints and the story on which we based our purchase is no longer valid, we are going to sell.

TWST: What is the turnover generally?

Mr. Moroney: For the small cap portfolio, I would say it is in the range of 75% to 100% a year. For the Best Ideas portfolio, I would put it at 50% to 75%.

TWST: To illustrate the discipline, do you have any stocks that you can tell us about that you had to sell or pare back?

Mr. Moroney: **Pacific Sunwear** (PSUN) was a very cheap retailing stock, and results actually weren't too bad. But they came out at the end of last year and said April quarter earnings would be flat, and we couldn't justify being in a retailer with no operating momentum.

One stock we sold with a big gain was **Steiner Leisure** (STNR). The Quadrix overall score had fallen to 70, down from 95 or higher when we originally put it on. The stock had moved to 17 times year-ahead earnings, versus a historical average of about 12. It just seemed like the risk/reward was not quite so favorable anymore, so we sold and put our money into another idea.

TWST: Have you been underweighting your consumer stocks?

Mr. Moroney: We have been underweighting consumer staples, but we are about equal-weight in consumer cyclicals.

TWST: Where would you say that you are underweight from your benchmarks?

Mr. Moroney: Interestingly, right now we are underweight in health care. That's a bit uncomfortable for us. Historically, health care has been an area where we have had a lot of success, and it is an area where we continue to view the prospects for growth as pretty solid. But, in our opinion, there is now a relative scarcity of attractive health names.

TWST: How do you try to control risk in your portfolio?

Mr. Moroney: First, we keep a close eye on our industry and sector exposures. I'm not too concerned with how a sector's exposure compares to the S&P 500 or any benchmark. But, I am concerned with a sector's exposure as a percentage of the total portfolio. We don't want one or two sectors to dominate a portfolio. Generally, if a sector is more than 20% to 25% of a portfolio, I'm going to take a real hard look and ask whether I want it to be that heavy.

Another way we control risk is to limit the size of individual positions. If a stock comes to represent 5% or 7% of a portfolio, we are going to trim it back and get the portfolio back in line. We re-

ally believe that discipline is our friend. The more we can make investing a process, the better off we are going to be.

In addition to spreading our bets over many names and keeping industry exposures broadly diversified, we sell quickly if something is not conforming to our rationale for purchasing the stock. We're not afraid to admit we made a mistake.

TWST: Who are your typical investors?

Mr. Moroney: Our typical investors are high net worth individuals who either have heard about us through the newsletters or, increasingly, through word of mouth.

TWST: What do you think differentiates your investment approach at Horizon from that of other companies? What are you bringing to the table that others might not?

Mr. Moroney: We do a good job of staying disciplined and staying humble. When you hear some money managers talk, they are trying to predict what's going to happen. Our goal is not to predict whether the market or a particular stock will go up or down — our goal is to make money by employing a disciplined system and keeping our ego out of it. The fact that we use Quadrix to skim the cream puts us ahead of a lot of other investors who don't have a disciplined system. One thing I've learned is that simply avoiding problematic stocks can really help performance. Merely avoiding stocks that score poorly, which can really torpedo your portfolio, will put you well ahead of the game.

TWST: What are the challenges that you see ahead this year from an investment point of view?

Mr. Moroney: One challenge we have now is the leadership in the market. We've had a very broad market advance, in which the typical stock has far outperformed the S&P 500 and Wilshire 5000 Indices. And while it's important to know whether the market as measured by the S&P 500 or Wilshire 5000 is attractively priced or not, that is not the central question. What matters is the availability of attractive stocks. And, if you look at the broad market, it has become somewhat expensive in some of the areas that have done best. Shares of companies with good operating momentum have moved to premium valuations relative to his-

torical norms. I'm speaking about areas like money management and brokerage, industrial groups, and some consumer groups.

So, among companies with operating momentum, it has become tougher to find cheap stocks. We are still able to do it. There are still opportunities out there. But when I compare where we are today with where we were two years ago, it has become more difficult to find those companies that have everything going for them that are also cheap.

TWST: Is there anything you would like to add or any summary statement?

Mr. Moroney: The things we are doing are very applicable whether or not you want to use Horizon Investment Services. I often read that the odds are stacked against individual investors — people picking stocks one at a time. I would argue it's exactly the opposite. The odds are in your favor if you stick with a system. As long as you are disciplined and don't let good results go to your head — or let bad results get you discouraged — your odds are better with an equal-weighted portfolio of 35 to 50 well-researched names than they are with an index fund weighted by market capitalization.

Remember, the question is not whether or not you can keep pace with the market. The question is how you can best grow your wealth. The stock market should figure prominently in that objective — provided you have discipline and a plan of attack.

TWST: Thank you.

Note: Opinions and recommendations are as of 5/8/06.

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