THE FORTUNE 40 BEST STOCKS TO RETIRE ON

Our trademark long-term portfolio can help put you on the road to a secure future.

BY PAUL R. LA MONICA AND KATIE BENNER


RETIREMENT
AHEAD
FORTUNE40

WELCOME TO THE AGE OF ANXIETY. Over the past year, fear, betrayal, and confusion have roiled investor confidence, leaving stomachs queasy and unsettled. Every day, it seems, some giant bank or Wall Street titan discovers a few billion dollars more in troubled assets it didn't realize it owned and now has to write down. Whether it's been the immolation of Bear Stearns, the descent of home prices, or the credit freeze—we're not even going to talk about skyrocketing prices for food and energy—the news has been wrenching.

With all that turmoil, perhaps it's surprising, then, that the major stock indexes haven't sustained more calamitous declines. Sure, they've all slipped 10% or so from their heady peaks in 2007, when credit was free, mega-mergers abounded, and every flower bloomed. (At least that's how it seemed.) A 10% drop certainly qualifies as a lousy run, but it's a far cry from the 20% fall widely viewed as the definition of a bear market. Indeed, it's precisely the fact that shares haven't fallen further that worries some investors. With the economy skidding, doesn't more trouble loom for stocks?

That's where the *Fortune* 40 comes in. We created our flagship retirement portfolio in 2002 with the goal of gathering a rock-solid, diversified group of stocks that could thrive in good times and hold steady in bad. Most of all, the portfolio is designed to be maintained over the long term. Given that philosophy, we don't quake when markets are troubled for shorter periods. Heck, there may even be a buying opportunity or two available.

All things considered, the portfolio performed relatively well in the past year, declining 2.3%. That figure isn't normally something to crow about, but it easily beat the S&P's 8.0% loss during the same time. Our longer-term results are even better. Since its establishment in 2002, the *Fortune* 40 has generated an average annual return of 15%, besting the S&P's 11%.

Since 2002 the Fortune 40 has averaged returns of **15%** *a year, outpacing the 11% of the S&P 500.*

Among our stars last year were international picks, which rose a collective 12.9%, and (surprise, surprise) energy selections. Brazilian oil producer **Petrobras,** which fit both categories, soared above the others with a 163% leap. The dogs were led (also no shock) by the financial stocks. Swiss bank UBS, for example, cratered 60% under the weight of bad subprime loans and too much risk taking.

Despite the occasional clunker, we still strongly believe in our methodologies, so we're sticking with them. Once again we've divided the collection into five mini-portfolios, each of which is modeled after the stock-picking strategies of the investing world's brightest minds: Jeremy Siegel, Peter Lynch, Benjamin Graham, Chuck Royce, and John Templeton. (Siegel is the only one who has blessed our use of his methodology, though he offers no view on our individual stocks.) We apply a series of screens based on each investor's philosophies and then refine the selections by interviewing top fund managers and grilling analysts.

Of course, even a long-term view requires flexibility and periodic pruning. So this year we're replacing 17 stocks that no longer pass our tests (including some, like Petrobras, that we wouldn't buy now because their success has made them pricey). Among the new crop: **BP, US Bancorp,** and some promising stocks you've probably never heard of. Read on for more details on some of the new entrants in each category (the specific screening methodologies are explained in the footnotes to the tables), as well as for data on each company. To find additional information on the stocks, including more on how last year's portfolio performed, go to fortune.com/fortune4O.

GROWTH AND INCOME

This screen is based on Wharton professor Jeremy Siegel's 2005 book, *The Future for Investors.* Siegel's research revealed the stellar results of what he dubbed "corporate El Dorados"—brand-name (but sometimes

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dowdy) companies whose products have decades-long track records of reliable sales. Siegel's formula: large-company stocks trading for less than 27 times earnings for the past 12 months, with dependable profit growth and a strong history of rising dividends.

Last year's returns may not have taken investors to any sort of mythical golden land, but they didn't drag them into the slums either. The group mustered an average total return of 2.9%. For that reason, we've kept the portfolio largely intact. Drugmaker **Wyeth** has been expelled, however, since analysts expect it to eke out profit growth of only 3% a year. We've cut **Altria** loose as well. Now that it has spun off Kraft Foods and Philip Morris International, all that's left is the anemic U.S. cigarette business.

To replace them we've added **US Bancorp,** one of the few big commercial banks to largely avoid the subprime mortgage meltdown. The company attracted us because of its conservative lending practices and its 5.1% yield. It also didn't hurt to see Warren Buffett's Berkshire Hathaway increase its stake in the first quarter. (As of March 31, Berkshire was the bank's biggest shareholder, with nearly 4%.) "It always makes me feel good when you see Buffett in a stock you own," says Blake Howells, director of equity research for Becker Capital Management. Shares of US Bancorp are up 5% in 2008 (perhaps in part because of the Buffett effect). Yet the stock still trades at a price/earnings ratio of 13, compared with an average 19 for other big financial institutions. (All P/E ratios, with the exception of those in one table, are calculated using profits for the prior 12 months. The P/Es in the deep value table factor in three years of profits to reflect Ben Graham's methodology.)

We're also recommending **Illinois Tool Works, an**

GROWTH AND INCOME

FINDING YOUR WAY TO EL DORADO

- **BLUE CHIPS** *with marquee brands often have hefty overseas sales that can provide a hedge against the weak dollar.*
- *Big-company stocks with* **STRONG DIVIDENDS** *tend to deliver steady returns and outperform glitzier names in troubled markets.*

OUR PICKS COMPANY TICKER (name in blue = new to list)	PRICE[1]	52-WEEK LOW–HIGH	MARKET CAP BILLIONS	P/E RATIO[2]	EARNINGS GROWTH[3]	DIVIDEND YIELD	WHY WE LIKE IT
Abbott Labs ABT	$56	$50–$61	$83.6	19	11%	2.6%	*Sales of bipolar/epilepsy drug Depakote are climbing, and the stent business is gaining market share.*
Coca-Cola KO	$57	$51–$66	$133.5	20	9%	2.7%	*Coke still has some pop left as burgeoning international sales and a weak dollar lift profits.*
Colgate-Palmolive CL	$73	$64–$82	$37.1	21	11%	2.2%	*Toothpaste giant has pricing power, and demand is growing for higher-margin organic products.*
General Mills GIS	$63	$51–$64	$21.0	18	9%	2.5%	*Rising food prices and new foods are providing a boost for the maker of Cheerios, Progresso, and Yoplait.*
Illinois Tool Works ITW	$52	$46–$60	$27.7	15	11%	2.2%	*Diversified industrial conglomerate has track record of many small but profitable acquisitions.*
Johnson & Johnson JNJ	$67	$60–$69	$183.6	16	9%	2.7%	*Cost cutting and a promising new-drug pipeline should lead to healthy earnings growth for years to come.*
Procter & Gamble PG	$65	$61–$75	$198.0	20	12%	2.4%	*Sale of Folgers coffee allows P&G to focus on faster-growing brands like Bounty and Olay.*
US Bancorp USB	$33	$28–$35	$57.0	13	8%	5.1%	*One of the few banks to avoid the subprime meltdown, it's also a favorite of Warren Buffett's.*

CRITERIA INCLUDE LONG-TERM EARNINGS GROWTH EQUAL TO OR GREATER THAN THE S&P 500'S ESTIMATED 7% RATE, DIVIDEND YIELD GREATER THAN THE S&P'S 2%, AND P/E RATIOS BELOW 27. [1]AS OF JUNE 2, 2008. [2]BASED ON THE PREVIOUS 12 MONTHS' REPORTED EARNINGS. [3]WALL STREET ESTIMATES FOR THE NEXT THREE TO FIVE YEARS.

industrial conglomerate with almost a century of smart acquisitions. The company makes everything from bolts and nuts to ovens, plastic bags, and flooring materials. "You hear business school professors talk about widgets. [This company] literally makes widgets," says Ted Parrish, co-manager of the Henssler Equity fund. "Illinois Tool Works is to industrials what Johnson & Johnson is to health care. It's a mutual fund of industrial companies." Earnings at Illinois Tool, which trades at a modest discount to competitors, are expected to increase at an 11% annual clip for the next few years.

BARGAIN GROWTH

This screen was designed to identify great growth stocks selling at reasonable prices. The portfolio uses the favorite valuation metric of the legendary former Fidelity Magellan fund manager Peter Lynch, the price/earnings to growth, or PEG, ratio. The goal is to find stocks whose share price doesn't reflect their huge potential. We also make sure they have low debt loads to avoid financial bombshells.

Lynch's approach isn't foolproof. This mini-portfolio stumbled last year, with a negative total return of 12.2%. The big declines were concentrated in two stocks. Shares of insurer **American International Group** were pulverized because of subprime-related losses. And **UnitedHealth,** like other HMOs, has seen its earnings growth slow dramatically because of increasing pricing pressures. Neither qualified for the list this year because of rising debt loads. The screen also eliminated **ConocoPhillips,** since its projected growth rate is no longer high enough.

Among our additions is **Walgreen.** The drugstore chain is operated in sober fashion: It has no debt and

BARGAIN GROWTH

EXPANSION ON THE CHEAP

- *Peter Lynch's favorite metric, the PEG ratio, helps identify stocks* **POISED FOR FLIGHT** *but priced at a discount.*
- *The PEG can uncover what Lynch called* **"STALWARTS"** *with the potential to rise 30% or more.*
- *Investing in companies with low debt loads can help investors* **AVOID A FINANCIAL BOMBSHELL.**

OUR PICKS COMPANY TICKER (name in blue = new to list)	PRICE[1]	52-WEEK LOW–HIGH	MARKET CAP BILLIONS	PEG RATIO	EARNINGS GROWTH[2]	DEBT/ EQUITY RATIO	WHY WE LIKE IT
Accenture ACN	$41	$32–$44	$22.7	1.1	13%	0	*Consulting is lucrative; with 94 of the Fortune Global 100 as customers, Accenture has a client list to envy.*
Chubb CB	$54	$46–$56	$19.3	0.9	9%	0.24	*Leader in the profitable niche market of insuring fine art, jewelry, and other luxury goods.*
Cisco Systems CSCO	$26	$22–$34	$152.2	1.3	14%	0.19	*Cisco is diversifying and primed to be one of the biggest beneficiaries of the broadband build-out.*
McKesson MCK	$57	$51–$68	$16.6	1.1	13%	0.29	*With many brand-name drugs coming off patent soon, sales should soar for the generic-drug distributor.*
3M MMM	$76	$72–$97	$54.4	1.3	11%	0.33	*Post-it maker is becoming more of an industrial tech company. Also, overseas sales are boosting profits.*
Microsoft MSFT	$28	$27–$38	$262.3	1.2	12%	0	*The software behemoth continues to ooze cash and expand into burgeoning new worlds such as videogames.*
Parker Hannifin PH	$83	$58–$87	$14.0	0.9	19%	0.23	*Demand for fuel-efficient jets is propelling profits for PH, which supplies equipment to Boeing and Airbus.*
Walgreen WAG	$36	$33–$48	$35.2	1.1	14%	0	*An effective strategy of growing from within makes the leading drugstore chain one of the safest bets in retail.*

CRITERIA INCLUDE PEG RATIOS (PRICE/EARNINGS RATIO DIVIDED BY EARNINGS GROWTH RATE) BELOW S&P 500'S PEG RATIO OF 2.2, LONG-TERM EARNINGS GROWTH EQUAL TO OR GREATER THAN THE S&P 500'S ESTIMATED 7% RATE, AND A DEBT-TO-EQUITY RATIO BELOW 0.33. [1]AS OF JUNE 2, 2008. [2]WALL STREET ESTIMATES FOR THE NEXT THREE TO FIVE YEARS.

RING: ALAMY; TAPE: DAVIES & STARR

has historically eschewed the types of huge mergers that have hurt many of its competitors. The increasing sales of generic drugs may be bad news for big pharma, says analyst Chris Armbruster of Al Frank Asset Management, but they could be "a very big windfall for Walgreen." That's because generics have higher profit margins for retailers. The result: Earnings are expected to escalate at a 14% annual rate for the next few years. Despite that, the stock sells at a modest discount, a P/E of 17, compared with 19 for other drugstore chains.

We're also introducing an indirect energy play. **Parker Hannifin** sells hydraulic components to oil and gas companies and makes control systems for aerospace firms. The means the company hauls in cash from both oil companies *and* aircraft makers like Boeing and Airbus. "Even though airlines aren't making money, they are ordering new planes like crazy because they need more fuel-efficient jets," says Craig Hardy, manager of the Huntington Income Equity fund. The stock, with a P/E of 16, is a bargain, considering that analysts expect profits to rise 19% annually, on average, over the next few years.

DEEP VALUE

Benjamin Graham, the legendary father of value investing, was never afraid to recommend stocks most investors shunned. In fact, he often preferred them. Our deep-value screen searches for stocks that he would approve of—those that may seem out of favor but that offer predictable earnings expansion as well as low debt and rising dividends. In other words, these are not stocks for those expecting big short-term pops.

Last year's picks sank 7.7% on average, just a whisker above the S&P 8.0% decline. Oil services and

DEEP VALUE

THE TARNISHED GEMS

- **IT TAKES NERVE** *to buy stocks in out-of-favor industries, but excellent bargains can be found.*
- **CONSISTENT PROFIT GROWTH** *and steady dividends might signal that a low-priced stock is ready to rebound.*
- *We all love to buy at a discount, but beware: Some stocks are* **CHEAP FOR GOOD REASON.**

OUR PICKS COMPANY TICKER (name in blue = new to list)	PRICE[1]	52-WEEK LOW–HIGH	MARKET CAP BILLIONS	P/E RATIO[2]	CURRENT RATIO	DIVIDEND YIELD	WHY WE LIKE IT
Applied Ind. Tech. AIT	$28	$22–$36	$1.1	13	3.3	2.2%	*Maker of bearings and transmission components generates cash; a stock buyback is also expected.*
Carlisle Cos. CSL	$33	$29–$52	$1.9	11	2.8	1.8%	*Several years of double-digit profit growth projected at this maker of construction materials and roofing.*
Cascade CAE	$48	$40–$90	$0.5	13	3.4	1.4%	*Light-truck sales may be weak, but demand is strong for Cascade's forklifts and industrial trucks.*
National Presto Ind. NPK	$65	$46–$67	$0.4	12	4.9	1.5%	*Diverse products (ammo, diapers, appliances) have helped profits thrive in economies both good and bad.*
Pfizer PFE	$19	$18–$28	$130.4	9	2.4	6.9%	*Pharma stalwart's new focus on cancer drugs is promising; juicy dividend pays investors for the wait.*
Regal Beloit RBC	$46	$33–$59	$1.5	13	2.4	1.3%	*Green trend should continue to be lucrative for this manufacturer of energy-efficient motors.*
UST UST	$55	$47–$60	$8.3	16	2.1	4.5%	*Shift to smokeless tobacco is fanning revenues. Hefty dividend and growing wine business add buzz.*
VF Corp. VFC	$75	$64–$96	$8.4	13	2.2	3.1%	*Hip brands like The North Face and Vans, as well as strong sales of jeans abroad, offset weakness in U.S.*

CRITERIA INCLUDE PRICES NO MORE THAN 15 TIMES AVERAGE EARNINGS PER SHARE OVER THE PAST THREE YEARS, TEN YEARS OF POSITIVE EARNINGS, ANNUAL PER-SHARE EARNINGS GROWTH OF 3% OR MORE, TEN YEARS OF UNINTERRUPTED DIVIDENDS, AND CURRENT RATIO (ASSETS DIVIDED BY LIABILITIES) OF TWO OR BETTER. [1]AS OF JUNE 2, 2008. [2]BASED ON AVERAGE THREE-YEAR EARNINGS.

equipment companies **Tidewater** and **Lufkin** buoyed the group, but neither qualifies as a bargain any more. We've ousted **Carpenter Technology** because demand has dropped for its steel alloy products, and dropped health insurer **Aetna** and conglomerate Loews because they have become too expensive.

We are, however, keeping **Pfizer,** whose dismal returns have caused many a headache in recent years. But with a P/E of nine, compared with the average 13 for Big Pharma, it's just the sort of stock that a contrarian like Ben Graham would hold on to. The company's earnings are expected to grow only 4% annually in the next few years, but hopes are high for some of its cancer drugs, such as Sutent, a kidney- and digestive-tract treatment. Meanwhile there's the 6.9% dividend (backed by $29 billion in cash) to soothe investors.

We found several more investments that Graham would love. Two of them are tiny, with market caps well under $1 billion, but their combination of discount share price and strong earnings makes them worthy candidates. **Cascade,** a manufacturer of forks, clamps, and other products for industrial trucks, has seen its stock sag on concerns about the sluggish economy and slowing sales of light trucks. That has depressed Cascade's P/E to 13, vs. 16 for other truck and farm-equipment makers. But Barry James, a portfolio manager with James Advantage Funds, argues that Cascade's shares will "pay off if you are patient." Demand is still healthy for commercial trucks, and analysts expect the company's profits to increase 7% a year for the next three to five years.

Then there's **National Presto Industries.** The company churns out a curious mix of products: appliances like pressure cookers and waffle irons under the Presto

SMALL WONDERS

LITTLE ENGINES THAT CAN

- *Small stocks are* **OFTEN IGNORED BY WALL STREET ANALYSTS,** *creating opportunities.*
- *Look for* **HEALTHY FREE CASH FLOW.**
- **FINANCIAL STRENGTH** *is crucial, since small firms can be especially fragile during bear markets.*

OUR PICKS COMPANY TICKER (name in blue = new to list)	PRICE[1]	52-WEEK LOW–HIGH	MARKET CAP BILLIONS	P/E RATIO[2]	RETURN ON ASSETS	FREE CASH FLOW[3] MILLIONS	WHY WE LIKE IT
Adtran ADTN	$24	$17–$29	$1.5	22	15%	$82	*With great management and lots of cash, this networking-equipment maker can weather telco turmoil.*
AVX AVX	$13	$12–$18	$2.3	15	8%	$193	*Electronics-parts manufacturer is using cash to boost its dividend and buy back stock.*
Fair Isaac FIC	$24	$21–$41	$1.2	13	8%	$156	*When housing revives, so will the need for Fair Isaac's flagship product, the FICO score.*
Global Industries GLBL	$17	$15–$29	$1.9	15	9%	$206	*Ever-increasing energy demand should mean business for this offshore-drilling support company.*
Grey Wolf GW	$8	$5–$9	$1.4	12	12%	$76	*A merger with Basic Energy Services will give this natural-gas driller more benefit from rising oil prices.*
Penn Virginia Resources PVR	$28	$18–$33	$1.3	23	10%	$80	*Earnings expectations have increased for the company's coal- and gas-processing divisions.*
Plexus PLXS	$28	$18–$32	$1.2	15	10%	$55	*As more companies outsource manufacturing, this specialty-parts maker rakes in new orders.*
Tessera Technologies TSRA	$20	$11–$45	$0.9	15	14%	$72	*Ever-shrinking gadgets mean more work for this developer of miniaturization technology.*

CRITERIA INCLUDE MARKET CAPITALIZATIONS BETWEEN $250 MILLION AND $2.5 BILLION, AT LEAST 8% RETURN ON ASSETS, POSITIVE FREE CASH FLOW, AND SHARE PRICE NO HIGHER THAN $35.
[1]AS OF JUNE 2, 2008. [2]BASED ON THE PREVIOUS 12 MONTHS' REPORTED EARNINGS. [3]LATEST FISCAL YEAR.

SHUTTERSTOCK

brand name but also diapers and ammunition (we assume the latter two are aimed at different customers). Annual profits have jumped 29% for the past five years, and Value Line expects them to increase an average 11% over the next two years. Fans include Chuck Royce (see next section), whose firm is the company's largest institutional investor. Despite stellar profit growth, National Presto's shares sell at a P/E of 12, compared with a range of 12 to 15 for competitors.

SMALL WONDERS

Last year was a bad one for small-cap stocks—the Russell 2000 index dropped 14%. Our group easily exceeded that sorry benchmark but still lost 7.3%.

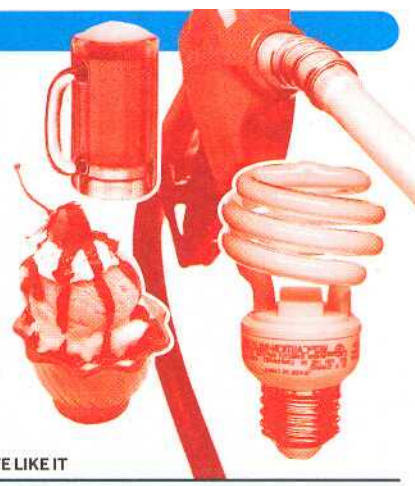
We continue to rely on the guidelines used by Chuck Royce, founder of Royce Funds and one of the gurus of small-cap investing. We select only companies with market caps between $250 million and $2.5 billion that trade for less than their enterprise value. The candidates also need an 8% return on assets and positive free cash flow. Finally, we consider only stocks with P/E or price-to-book ratios lower than that of the Russell 2000 and include only stocks priced below $35 a share. Given their small floats and low prices, these stocks are less likely to be owned by large mutual funds or covered by the major Wall Street firms. That means less of a chance that share prices have already been pushed upward.

We've jettisoned five of the eight stocks we held last year. We decided that **CSG Systems'** best days might have passed, even though it still has a lock on the cable billing and service market. Its customers are hurting and will no doubt try to keep their costs low. That means less money for CSG, and the market has punished its stock with a 50% fall. Chemical maker

FOREIGN VALUE

A WORLD OF POSSIBILITIES

- *Many non-U.S. companies* **STILL APPEAR UNDERVALUED,** *despite years of strong growth overseas.*
- **EMERGING MARKETS** *are risky, as always, so target the bulk of your investment toward developed countries.*
- *Search for stocks that are selling* **NEAR OR BELOW BOOK VALUE,** *or at low price/earnings multiples.*



OUR PICKS COMPANY TICKER (name in blue = new to list)	PRICE[1]	52-WEEK LOW–HIGH	MARKET CAP BILLIONS	P/E RATIO[2]	EARNINGS GROWTH[3]	DIVIDEND YIELD	WHY WE LIKE IT
BP BP	$71	$58–$80	$220.9	9	13%	4.7%	*Britain's energy giant is improving operations and putting high-profile mishaps in the past.*
Diageo DEO	$77	$73–$93	$50.0	17	17%	2.6%	*This worldwide spirits company has an edge in fast-growing developing markets.*
Novartis NVS	$54	$46–$60	$120.9	19	14%	2.5%	*An industry-leading roster of late-stage drugs should compensate when blockbusters lose patent protection.*
Philips Electronics PHG	$38	$35–$46	$39.4	8	14%	2.4%	*A new focus on its most lucrative divisions should boost margins and smooth earnings.*
Sanofi-Aventis SNY	$37	$35–$49	$96.4	13	45%	3.1%	*This French drugmaker's specialty is addressing ailments that have no other treatment.*
Total TOT	$87	$67–$91	$190.3	9	5.1%	3.1%	*French oil conglomerate is shedding noncore businesses and beefing up exploration.*
Unilever UL	$33	$29–$38	$23.1	4	6%	4.0%	*The consumer brand behemoth is focusing on booming emerging markets.*
Vodafone Group VOD	$32	$29–$41	$168.3	29	8%	6.3%	*The global telecom company has enough cash to grow through strategic acquisitions.*

CRITERIA INCLUDE LOW PRICE/EARNINGS AND PRICE/BOOK RATIOS RELATIVE TO COMPETITORS, RISING PROFIT MARGINS, AND ACCELERATING EARNINGS GROWTH.
[1]AS OF JUNE 2, 2008. [2]BASED ON THE PREVIOUS 12 MONTHS' REPORTED EARNINGS. [3]WALL STREET ESTIMATES FOR THE NEXT THREE YEARS.

BONDING AGAINST INFLATION

Here are three strategies to fend off the kind of pain that rising prices can impose on fixed-income investments.

Inflation inflicts many harms, but it can be particularly brutal in eroding the value of bonds. As commodities prices soar and the dollar falls, this specter seems increasingly possible. What's an investor to do? First, become a commitment-phobe: Stick with short-term U.S. Treasury notes or low-cost funds such as **Vanguard's Short-term Treasury fund (VFISX),** which has averaged 3.4% returns over the past five years. Second, get defensive. **TIPS** (Treasury inflation-protected securities) are the easiest and safest way to buy inflation protection and are sold directly by the Treasury at treasurydirect.gov. The value of the principal adjusts with the consumer price index. Keep in mind, though, that TIPS are best held in a tax-deferred account or a Roth IRA; otherwise taxes can eat away some or all of the returns. Also, investors have poured into short-duration bond funds and TIPS of late, pushing yields down. The ten-year TIPS is yielding 1.6%, vs. 3.9% for a ten-year note. One alternative: certificates of deposit inflation-protected securities, or CDIPs. These CDs pay interest on an inflation-adjusted principal, are insured by the FDIC, can be purchased at banks and brokerages—but have the same tax consequences as TIPS. Third, investors may want to go global. Kathleen Gaffney at Loomis Sayles advocates bonds of countries where growth looks healthy and the currencies are strong. Jim Peterson of Charles Schwab suggests bonds of commodities-rich countries as an inflation hedge. As commodities prices rise, those currencies also improve against the dollar. Both options are great for professional managers, but retail investors will do better with funds that employ these strategies. For example, **consider the Western Asset Inflation Indexed Plus Bond fund (WAIIX), which** Morningstar ranks in the top 3% of funds in its category. This fund has averaged 5.3% returns over five years and balances the foreign bonds with Treasuries and investment-grade corporates.

Hercules, laptop component maker **Park Electrochemical,** retailer **K-Swiss,** and consulting company **Navigant** no longer met our criteria because return on assets dipped below 8%.

Our replacements include **Adtran** and **AVX.** As telecom companies and corporations upgrade to high-speed networks, they rely on equipment made by Adtran. The firm has posted 20% or better operating margins in eight of the past ten years, and revenue and earnings are expected to grow by an average of 10% or more over the next three years. The company not only is an important player in a networking build-out but also has the balance sheet to handle financial storms. Its $50 million in debt is more than offset by $300 million in cash, and the company generates $82 million a year in free cash flow.

AVX has higher risk because it's in electronics, a very cyclical industry. The company makes parts that regulate electricity in virtually all electronic devices, and it is 71% owned by Japan's Kyocera. The company has no debt and a growing pile of cash it can use to make strategic acquisitions or wait out the down part of a cycle. Plus, its P/E of 15 is less than half that of its closest competitor.

FOREIGN VALUE

The fastest economic growth these days is taking place outside the U.S. Needless to say, smart investors need international exposure, and our strategy paid off last year with an overall 12.9% gain.

In this category we emulate the approach of John Templeton, founder of the Templeton mutual fund and one of the first American fund managers to shop abroad. That means screening for stocks selling below book value or at P/E ratios lower than those of their competitors. We seek companies with potential for earnings growth and expanding profit margins. One reason they have that potential is that they do a lot of business in developing nations but are bolstered by the stability of being based in developed countries.

We chose BP because like all integrated oil and gas majors, it is awash in cash as oil and gas prices climb ever higher. But the British oil giant has a low P/E of nine (compared with 11 for Chevron or Exxon Mobil), partly from turmoil in its joint venture with Russian oil producer TNK-BP, which accounts for a third of BP's oil production. With Russia increasingly pressuring foreign companies in the energy business, there are fears BP will be squeezed out. However, nearly all major oil companies have to work with unstable or unfriendly regimes these days, and BP has a diverse array of exploration and production operations around the world, including in Trinidad, Angola, and the Gulf of Mexico. Analysts surveyed by Capital IQ anticipate a 38% increase in earnings next year as the company completes repairs to a damaged refinery and puts costly litigation behind it.

Finally, **Philips,** the Dutch conglomerate, is in the middle of a promising makeover. It's focusing on its profitable lighting, medical device, and personal care divisions while shedding cyclical, low-margin businesses like television displays and semiconductors. Meanwhile the weak dollar is providing a jolt to its revenue, which should grow at about 5% annually for the next five years, with earnings expected to show double-digit growth. Philips also has modest debt and more than $8 per share in cash, and is trading at a reasonable P/E of eight. Those are the sorts of numbers that light up a portfolio.

ADDITIONAL REPORTING David *Stires*

Fonte: Fortune, v. 157, n. 12, p. 10-22, june 23 2008.