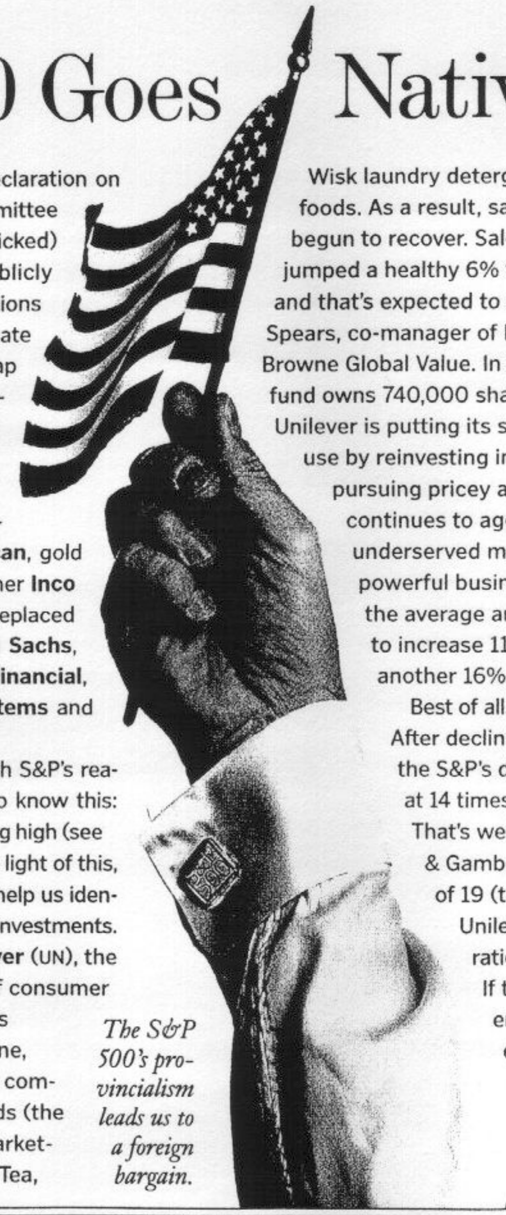
The S&P 500 Goes Native



The minders of the S&P 500 made a declaration on July 9 that startled the world. The committee that runs the closely followed (and mimicked) listing of the 500 most important publicly traded companies decreed that foreign corporations would no longer be included in the index. To create what S&P called "a better reflection of the large-cap segment of the U.S. equity markets," seven companies based overseas were given the proverbial boot. Those included two Netherlands-based corporations, oil giant **Royal Dutch Petroleum** and consumer-products behemoth **Unilever**. The others are based in Canada: aluminum producer **Alcan**, gold miners **Barrick Gold** and **Placer Dome**, nickel miner **Inco** and telecom-equipment maker **Nortel**. They were replaced by **eBay**, video gamer **ElectronicArts**, **Goldman Sachs**, life insurers **Principal Financial** and **Prudential Financial**, technology-services provider **SunGard Data Systems** and **United Parcel Service**.

Now we don't necessarily agree or disagree with S&P's reasoning for jettisoning these companies. But we do know this: The committee is notorious for selling low and buying high (see "Is the S&P 500 Rigged?" in our July 2001 issue). In light of this, we surveyed our favorite international investors to help us identify which of these ousted companies are attractive investments.

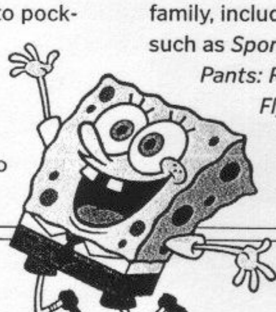
After careful consideration our choice is **Unilever** (UN), the Dutch multinational that produces a huge array of consumer staples. Over the past couple of years Unilever has made an effort to slenderize its bloated product line, which stood at around 1,600 brands in 2000. The company has since slimmed down to about 900 brands (the plan is to reach a svelte 400) and is placing its marketing muscle behind top performers such as Lipton Tea, Wisk laundry detergent and Slim Fast diet foods. As a result, sales and earnings have begun to recover. Sales were flat in 2000 but jumped a healthy 6% to $48 billion last year, and that's expected to continue, says John Spears, co-manager of MONEY 100 fund Tweedy Browne Global Value. In particular, Spears, whose fund owns 740,000 shares, likes the fact that Unilever is putting its strong cash flow to good use by reinvesting in its business rather than pursuing pricey acquisitions. Plus, Unilever continues to aggressively expand in underserved markets. "It's a pretty darn powerful business," he says. Indeed, the average analyst expects earnings to increase 11% in 2003, followed by another 16% rise in 2004.

Best of all, the stock price is alluring. After declining 20% to $53 following the S&P's dropkick, Unilever trades at 14 times estimated 2003 earnings. That's well below chief rival Procter & Gamble's estimated 2003 P/E of 19 (the S&P's is 15). Similarly, Unilever's price-to-cash-flow ratio of 7 is half that of P&G's. If that's not convincing enough, then perhaps the enticing 2.6% yield will lure you, the S&P 500 notwithstanding, to look abroad. —JEFF NASH AND NICK PACHETTI

The S&P 500's provincialism leads us to a foreign bargain.

It's the only game in town

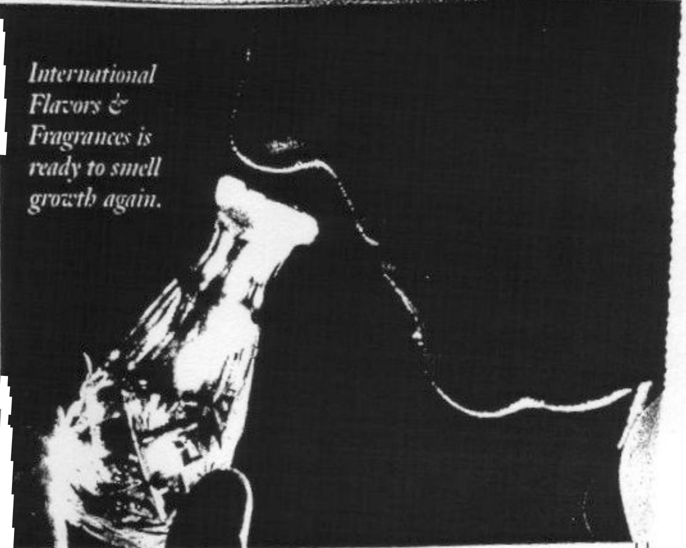
The video-game industry is reaching the point in its business cycle where families, as opposed to pockmarked geeks, will drive sales, and gamemaker **THQ** (THQI) is the best positioned to take advantage of this change. THQ, which develops programs for PlayStation 2, GameCube and Xbox, has the largest lineup of titles geared for the entire family, including favorites such as *SpongeBob SquarePants: Revenge of the Flying Dutchman.* Moreover, Wall Street darling Electronic Arts, THQ's archrival, is too pricey. At a recent $62, EA's shares change hands for 34 times projected 2003 earnings. THQ, at $22, trades at just 14 times estimated 2003 earnings. Plus, THQ has no debt, $229 million in cash, and is run by the best management in the business. Analysts expect THQ's earnings to grow by 28% in 2002 and by 23% in 2003. And that's just the beginning. According to CEO Brian Farrell, "If past cycles are any indication, 2004 and 2005 are going to be our best years ever." —N.P.



Families love THQ's SpongeBob SquarePants *video game.*

Homebound

America has always enjoyed a reputation for honest markets and unassailable


International Flavors & Fragrances is ready to smell growth again.

accounting practices. The recent barrage of corporate scandals may have put that high esteem in doubt. Rest assured, the U.S. is still better than anywhere else in the world, says the University of Indiana's Utpal Bhattacharya, who, along with fellow professors Hazem Daouk and Michael Welker, analyzed 58,653 financial statements from 34 countries filed between 1985 and 1998, covering nearly every foreign security a U.S. investor conceivably could have bought.

The professors ranked each country on the earnings quality of companies in that local market. They've dubbed the results the country's "earnings opacity," or lack of transparency, ranking.

Despite its recent warts, the U.S. is tops in earnings transparency, followed by Norway, Portugal and Brazil. Much further down the list is Germany (No. 15) and, in the

An academic study says the U.S. market is the world's most honest.

lowest quintile, Japan. Bhattacharya believes that despite the numerous accounting blowups of the past year, the U.S. will still rank in the top quintile when he updates the study. Bhattacharya notes, "The U.S. still has the most honest capital markets in the world." —CYBELE WEISSER

Sweetness

International Flavors & Fragrances (IFF), once part of the Nifty Fifty group of 1970s growth stocks, lost its way in the '90s. IFF—which makes the chemical formulas that are used to make food like french fries taste good and perfumes smell pretty—became too focused on developing exotic products rather than delivering what customers wanted on a timely basis. Between 1995 and 2001, earnings retreated by more than a third to $1.40 a share. The stock fell from a high of $53 in 1997 to less than $20 by late 2000.

Now there's a scent of a turnaround. New management led by Richard Goldstein, the former CEO of Unilever's U.S. operations, has reorganized IFF, consolidating plants and selling off less desirable units. These moves, as well as cost savings from a recent acquisition, are expected to save the company between $25 million and $30 million annually beginning this year.

At $29.50 in mid-July, the company sells at 15 times projected 2002 profits. Dan Cantor of Liberty Select Value thinks that once sales pick up, IFF can easily justify a multiple of 23 times earnings (or about $50 a share), more in line with its historical valuations. Says Cantor: "At this price, there's plenty of upside." —ADRIENNE CARTER

Hercules' hero?

Eighties corporate raider Samuel Heyman is back. This time Heyman, infamous for profiting from his unsolicited bids for Union Carbide and Borg-Warner, has set his sights on chemicals company **Hercules** (HPC).

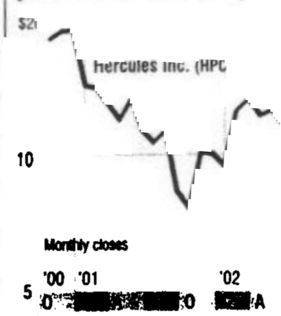
Heyman acquired a 9.9% share of Hercules through his 80%-owned company, International Specialty Products (ISP) in July 2000. Heyman then offered to buy another 23% of Hercules when it was trading for $14 a share that October.

Hercules' management spurned his bid but lost a proxy battle that helped elect Heyman and three other ISP nominees to the board in 2001. Although relatively quiet since his board appointment, Heyman finally erupted during Hercules' annual meeting on June 27. His litany of gripes includes the desperate sale of chemical company BetzDearborn (which Hercules bought for $3.1 billion in 1998 and sold to GE this spring for $1.8 billion) and fat paychecks to Hercules executives. Hercules CEO William Joyce defends the price and sale of BetzDearborn and says he considers the $10 million in bonuses paid to his top staff well deserved.

Some investors believe Heyman's tactics are a means to squash the stock price and grab control of the

IN PLAY

The battle over Hercules fate is well under way



Note: Data as of July 15. Source: Baselin

prized parts of the company. Others say he's merely trying to force a sale of Hercules to profit on his bet.

Hugh Evans, a fund manager and analyst with T. Rowe Price, which owns 7.6 million shares, sides wit Heyman in one respect: He thinks Hercules' stock, at $10 a share, is dramatically undervalued. Patient inves tors could see Herculean rewards. —DEREK MANS