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Money manager focusing on earnings, not the Fed's rate hikes

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The Journal Sentinel focuses on one Wisconsin money manager or analyst in this weekly feature, looking at a trend that helps investment pros make their decisions.

The Fed on Thursday raised interest rates again by a quarter-point and suggested there may be more to come. Smetek says the market, though, is already transitioning to a focus on earnings rather than interest rates - and he's prepared for the change.

"We think in very short order, investors need to be looking beyond the Fed and focusing on what the earnings potential is of the companies they're investing in," said Smetek, president and chief investment officer at Arcataur Capital Management LLC in Milwaukee.

The Fed has raised interest rates 17 straight times since June 2004, and most observers believe another hike is coming in August. Wall Street has reacted with concern, particularly in recent weeks. The broad-based Standard & Poor's 500 index has declined almost 3.3% since May 1.

The interest rate hikes, which Smetek says are part of what investors view as an interest-rate cycle the market has been going through, have lasted longer than most expected.

Part of the reason is that rates in the U.S. have been high relative to those of other countries, encouraging foreigners to continue investing in our bond markets, Smetek said. Investors in Arab countries, flush with profits because of higher energy prices, have also been putting money into U.S. markets, he said.

But interest rates in other countries are starting to look more attractive. Japan, for example, has been gaining economic steam to the point where policy-makers there are considering raising rates. And the Fed is likely near the end of its rate hikes.

"We're maybe in the eighth inning of the tightening cycle. Equity prices have come down and interest rates have moved up. We're into the earnings phase of the market," Smetek said.

Stock investors are being cautious, though. The U.S. stocks that have been hurt the most in the last two months were those of small companies. The Russell 2000 index, for example, has lost about 6.2% of its value since May 1, more than the S&P 500. Smaller companies tend to be more interest-rate sensitive and have less robust balance sheets than bigger companies.

"Rising rates and a subsequent fear of inflation have made investors more risk-averse," Smetek said.

He's addressing that by seeking companies selling at reasonable valuations that can deliver solid earnings growth. More often than not, those will be the bigger companies, he said.

Smetek likes to take what he calls a barbell approach in his clients' portfolios.

For the blue-chip portion of their portfolios, he chooses some safer, more defensive, big-company names for one end of the barbell. On the other end, he uses high-quality companies that have been "punished" by the market more than he believes they should have been.

Smetek owns several stocks that grew up in the technology boom of the 1990s and now are out of favor, like Cisco Systems Inc. (CSCO, $19.53), which makes networking and voiceover equipment, and Texas Instruments Inc. (TXN, $30.29), which makes semiconductors.

Both have market-leading qualities, but are trading at big discounts to their growth potential, he said.

Take Texas Instruments. The company invented the digital light processing, or DLP, chip that goes into many big-screen TVs and has been a leading innovator for the cell phone industry. Like the others, its stock is selling at a low price and it has potential to outperform if robust global sales of big-screen TVs and cell phones continue.

On the defensive side, Smetek owns stocks like:

• Citigroup Inc. (C, $48.25): As is true for other financial institutions, Citigroup historically does well after interest rate hikes end because it can better manage its assets. Smetek says he's gotten more interested in financial institutions and other interest-rate sensitive financials as the Fed has gotten closer to what he believes is the end of its rate hikes.

• Bank of New York Co. (BK, $32.20): It's one of the world's leaders in bank transaction processing so it should be able to improve its earnings as volume increases in world financial markets, Smetek said.

• General Electric Co. (GE, $32.96): More than half of GE's business is financial. The company also makes jet engines, power plant turbines, locomotives and medical imaging equipment. A true conglomerate, it is also involved in real estate, loans, aircraft leasing, plastics, large appliances, and security and water treatment.

GE's stock has been left behind in the last several years as investors focused on commodity-type plays in energy and other areas. Now it has a relatively low valu- ation and is well-positioned for the coming focus on companies that can generate good earnings growth, Smetek said.

Analysts expect the overall market to produce earnings growth of less than 10% next year, while GE should provide year-over-year earnings growth of about 14% in 2007, he said. Meanwhile, the company is selling at a price-to-earnings ratio of about 15 on 2007 earnings, he said.

"If we're right on this earnings phase, people will say GE is not expensive and it's growing faster than the market," Smetek said.

GE has been using its financial flexibility to increase its dividend and buy back shares. The company historically has been very good at making acquisitions, he said.

The biggest risk Smetek associates with this stock and the others is the possibility the market could focus on something perceived as more attractive, such as commodities like metals and energy, as it was doing earlier this year when investors focused on China's huge appetite for such items.

Smetek says he's not worried, though, because earnings growth will likely be more important going forward.

He is still buying GE for new accounts and says the shares could go as high as $42 in the next 12 months.

This column examines one stock through the eyes of a professional investor to show how market pros make investment decisions. Neither Kathleen Gallagher nor the Journal Sentinel recommends specific investments or endorses the recommendations of those interviewed.

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