

Note

April 9, 2008

Bombs and Fallen Angels

With Bear Stearns and Washington Mutual fresh in our memory, we have revisited the Fallen Angel topic. Initially, we'll use the term "Bomb" to refer to both Fallen Angels and Bombs, but later we'll draw a distinction between the two. Our previous studies focused on what to do once a Bomb occurs. In this study we'll first address how to avoid Bombs in the first place, which all will agree is the best way to deal with a Bomb.

How to avoid a Bomb? We examined Score, Columbine, S&P and Financial Strength ratings and evaluated their relationship to Bombs. As the charts in Appendix 1 attest, Bombs are unavoidable, but exposure to Bomb risk can be lessened by both our ratings and safety statistics. A Bomb was defined in this study as a stock above \$5 that fell more than 50% in a one-month period during the 2002-07 periods. So these are not garden-variety earnings misses, but rather dire company and/or industry developments. Per the charts, safety ratings do an excellent job of helping with Bomb avoidance. FnS BBB or better and S&P Rating B- to A+ are low-risk areas. Score also does an impressive job, particularly in the sub-40 region as a Bomb avoidance range. Stocks with Columbine 9 and particularly 10 ratings should also be avoided (per the footnote, do not directly compare percentages of this chart with the other three). We also looked at these relationships year-by-year and found the patterns to be stable through time. On average, you were 3-4 times more likely to wind up with a Bomb if a stock's Score was below 40 vs. above that.

What to do if you end up with a Bomb? We calculated the one-year normalized performance (stock performance minus universe average performance) following the quarter in which the Bombs occurred. We found that there were two distinct periods. 2002 was the final and worst year of the 2000-02 Dot-Com Bubble Burst and was characterized by widespread, indiscriminant selling. Evidence of this were the 66 Bombs in that single year. Per the huge average rebounds (a whopping 150pp better than average), that selling frenzy created tremendous contrarian opportunities, but the opportunity did not repeat in the subsequent intervals. During the years that followed, i.e. "normal" years, Bombs were less frequent (on average just over 10 per year) and had much poorer outcomes, lagging the universe average by 24pp. Of the 43 Bombs during the 2002-06 period, 63% lagged the universe average one year following their initial big hit.

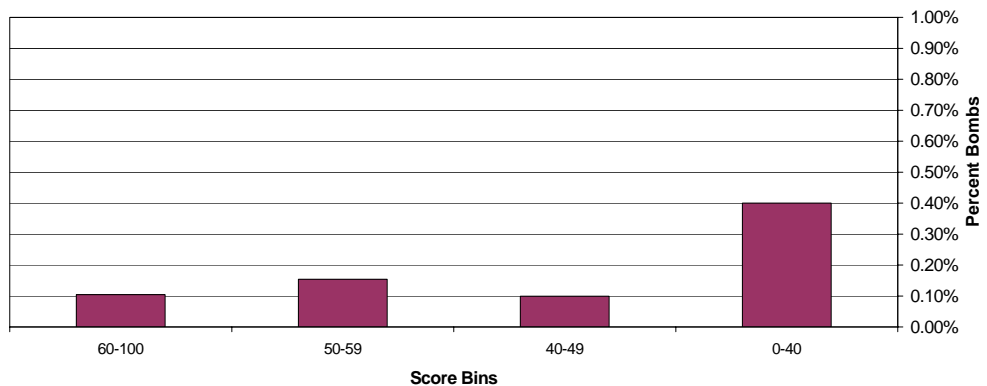
A Fallen Angel or a Bomb? At this point let's refine our definition of a Bomb to require a company-specific event rather than just being part of a widespread sell-off. Per this, the majority of the 2002 stocks in this analysis were not Bombs, so let's call these stocks instead Fallen Angels. With this distinction, guidance becomes clear. Use ratings and safety stats to avoid both Bombs and Fallen Angels, but when a Bomb occurs, Mike's advice to unload immediately is indicated. If instead you windup with a stock caught up in a general selling frenzy, a.k.a. a Fallen Angel, big recovery potential exists. One can tell the difference between a Bomb and a Fallen Angel by the prevalence of big hits occurring at the time and by news being specific to it versus that of a competitor or an industry.

In 2007 there were 47 Bombs/Fallen Angels, so roughly four-times the norm. So far in 2008, the incidence of Bombs/Fallen Angels continues to run high. This suggests there are likely Fallen Angel opportunities mixed in with the Bombs for those with a discerning eye.

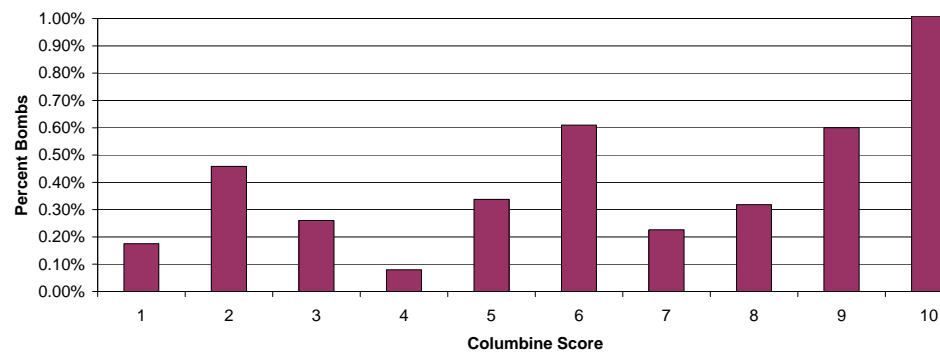
Appendix 1

* Columbine chart is based on 2007 data only

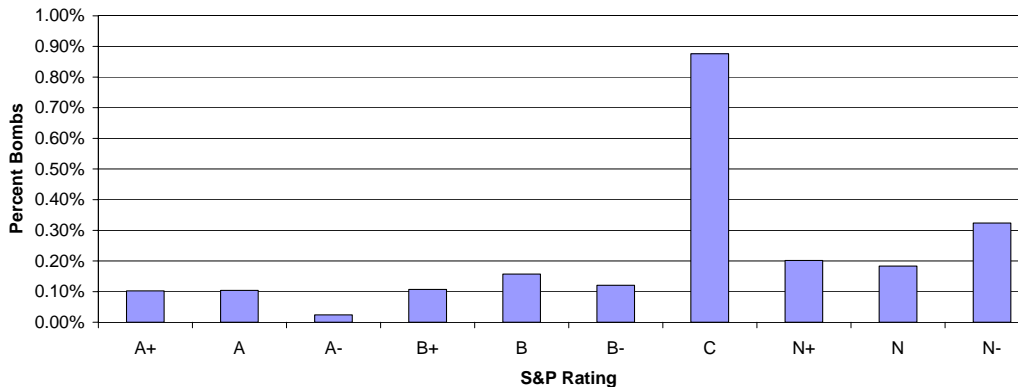
Distribution by Score of Fallen Angel Stocks
Stocks above \$5 which fell more than 50% in 1 month (2002-07)



Distribution by Columbine of Fallen Angel Stocks *
Stocks above \$5 which fell more than 50% in 1 month (2007)



Distribution by S&P Rating of Fallen Angel Stocks
Stocks above \$5 which fell more than 50% in 1 month (2002-07)



Distribution by Financial Strength

