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Stock Strategist

Ten Stocks for the Next Ten Years
By Pat Dorsey, CFA | 07-21-06 | 06:00 AM

Every once in a while, you read an article that sticks with you for a long time. One that I remember well--as a sobering reminder of the danger of following the herd--ran in the *New York Times* in late February 2000. The author asked 10 "very smart, very successful investment professionals" to each pick one stock for the next 10 years.

Predictably, given the market environment at the time, six of the 10 were tech stocks, with shares trading for an average price/earnings ratio of 70. (That's without including the stratospheric P/E of JDS Uniphase JDSU .) All six have been cut in half or worse over the past six years. Returns for three of the remaining four stocks ranged from flat to up 130%, with one stock shooting the lights out with a 650% return. The highest returns came from the two stocks that I'll bet most readers of the article at the time were least likely to buy--a struggling trash-hauler, and a distributor of dental equipment. It shouldn't come as any surprise that those stocks also sported single-digit P/Es at the time.

The lesson from this article was clear: Few things matter more in investing than the price you pay for the stocks you buy, and the companies that no one cares about are much more likely to be good buys than the ones topping the performance charts. And as I never tire of pointing out, the market's greatest irony right now is that no one seems to give a hoot about many of the world's highest-quality companies. Large caps as a group have simply stunk over the past five years, and broadly speaking, junk has crushed quality.

To be blunt, the market is offering an embarrassment of riches right now for long-term investors looking to build core holdings. But where do you start? We currently have about 150 stocks of reasonable quality--wide or narrow economic moats--that earn a 5-star Morningstar Rating for stocks. Even if we narrow the list to just wide-moat stocks, you still have 40 companies.

So, at the risk of looking foolish--which, I should note, is an occupational hazard in this profession--I've boiled down our wide-moat, 5-star list to just 10 stocks. These are 10 of the world's best companies, with competitive advantages that should enable them to

generate high returns on capital for many years to come. As a group, they trade for an average of 17 times earnings, and an average of 30% below our fair value estimates. I'd note that a P/E of 17 is about the same level as the broad market--so you're getting superb businesses for merely average prices.

How did I choose these 10 from our list of 40 wide-moat, 5-star stocks? Nothing magic. I own some of them, others are on my watch list, and others were picked based on input from the smart folks I work with. Most were judgment calls, and could have been replaced with other cheap wide-moat stocks without much of an argument. Overall, though, I just thought about which 10 I would buy today if I had lots of cash and was starting with a clean slate.

Starting alphabetically, there's Amgen AMGN , which from a financial perspective looks much more like a traditional big pharma firm than a biotech. Relative to many big pharma firms, however, it has a very strong pipeline, and it's more insulated from the threat of generics, since manufacturing a generic version of a biologic drug is much tougher than replicating the chemical structure of a small-molecule "traditional" pharmaceutical. At 15 times cash flow, the shares have a lot of bad news already baked in, and we think they're worth a lot more.

Next is Cadbury Schweppes CSG , a firm that may not be as well-known to U.S. investors, but which owns world-class brands like Dr. Pepper, Cadbury, and Trident. About three fourths of the firm's sales come from confections, which are less subject to the private-label competition that has eviscerated margins at many other packaged-foods firms. (When was the last time you bought store-brand chocolate or gum?) The firm gets a bit over half its sales outside the U.S., and when you add that kind of international diversification to a decent 2.5% yield, and a valuation of just 10 times cash flow, you've got a pretty good investment.

Then there's Dell DELL , which, in my humble opinion, is screamingly cheap. The firm's cost advantage has diminished, yes--but it hasn't gone away, and it's still meaningful. The company has successfully moved into non-PC markets, and is seeing success with its direct-sales model in places like China where skeptics thought it wouldn't work. The bottom line is that in commodity businesses, the low-cost producer wins in the end, and that's still Dell. (And yes, we still think it's a great buy even after today's warning. If pricing stays weak for an extended time, this may not be a $40 stock, but there's no way it's a $20 stock.)

Speaking of tech stocks that have gone from hero to zero in a heartbeat, there's eBay EBAY . We've been collectively scratching our heads over this one for the past few weeks as the price has collapsed, and the only reason I can think of as to why it's gotten this cheap is an utterly irrational fear of Google GOOG . I say irrational because eBay's core auction business is still doing just fine, the international sites are growing nicely, and that lovely pool of liquidity that forms the core of eBay's economic moat just gets bigger and bigger. We think eBay is worth much more than the current stock price. This is too good a business, growing too quickly, to stay at 20 times forward earnings for very long.

Moving from the new economy to the old, Fastenal FAST makes my top-10 list hands-down. Distributing fasteners to industrial firms may not sound like much of a business, but it's generated 20% compound growth and about 20% returns on invested capital for the past decade, and we think there's a lot more where that came from. Fastenal also boasts a truly stellar management team that's extremely shareholder friendly--the firm earns an "A" Stewardship Grade, something we don't hand out lightly. Looking at price multiples, it's the most expensive stock on my list, but we think that the shares are worth a good deal more based on our discounted cash-flow valuation.

Back to health care, I have to include Johnson & Johnson JNJ , which is the closest thing to a no-brainer investment I can find right now. I wrote about J&J extensively a few months ago, so I won't repeat myself here. Suffice to say that it's very cheap, and buying it today is likely to look very smart a few years hence.

Although J.P. Morgan Chase JPM had a big pop earlier this week, it's still very cheap at 1.3 times book value and a 30% discount to our fair value estimate. The firm is tops in many of its businesses, has the opportunity for substantial improvement in its return on equity, and is run by a smart, no-nonsense CEO who has something to prove to the world. It's tough to beat that combination, and you also can't argue with a nice 3.2% yield while you wait for the market to realize JPM's real value.

My other financial name is MasterCard MA , a company that's known to everyone, but very new to the public market. One of my colleagues laid out our case for the stock a couple of months ago before it went public, so I won't repeat the basics here. I'll just point out two things. First, the headlines may be ugly on the legal front, but the firm generates so much cash that it can afford to pay a lot of fines if it needs to. (We've baked about $2 billion into our valuation.)

Second, firms that go from being private partnerships to public for-profit entities typically see massive margin expansion as motivated managers find costs to cut. Look at any of the de-mutualized life insurers or the CME CME for examples of what this can do for a firm's returns on capital.

Next to last--but not least--there's medical-device firm Medtronic MDT , which is one of those wonderful franchises that got bid up to wacky valuations in the late 1990s, but which is now available for a very reasonable 17 times earnings. The firm has successfully diversified out of its core heart product market, and now gets a third of revenue from areas like diabetes, neurology, and spinal products. The market appears worried about a slowdown in Medtronic's core cardiac-device market and potential cuts in reimbursements from Medicare, but we think the first of these is a temporary issue, and the second is not likely to have as big an effect as the market thinks.

Finally, I'm going to pick food distributor Sysco SYY , one of those unsung businesses that simply cranks out cash year after year. The firm dominates the food distribution business with substantially higher market share (and profit margins) than its nearest competitor, and it's recently been widening its already-substantial competitive advantage by overhauling its distribution system. This isn't a flashy business, but it's one that will be around 10 years from now, likely with little diminution in competitive advantage.

Pat Dorsey, CFA, is director of stock analysis for Morningstar.

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