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With
Philip Durell
Motley Fool Advisor/Analyst

Values of the Month

MasterCard (NYSE: MA)
Amerigroup (NYSE: AGP)

What's New

This month, we have a guest analyst, Motley Fool health-care and biotech expert Charly Travers, who has made some excellent recommendations for the Fool's *Hidden Gems* and *Rule Breakers* newsletters. Charly's pick is small managed-care company Amerigroup, while my pick is recent IPO MasterCard. Both companies have higher risk ratings — for those who prefer lower risk, check out the BRAVO list on the scorecard page.

In last month's update, we highlighted posts from our vibrant discussion boards. Our boards are an excellent way to keep up with — and even participate in — key discussions about investing and about your companies.

Inside

Heard on the Boards

"This is a signal that the Internet wires were smokin' in the (Home Depot) board of directors offices. They got smoked over their corporate governance attitude — one of indifference. It is no secret now that they have been put on notice."

—**TMFRoZany** in post #142 on the IV Home Depot board.

Dear Fellow Fool,

I've been earning my fair share of frequent flier miles this month. My adventures included the **Berkshire Hathaway** (NYSE: BRKa) (NYSE: BRKb) shareholders weekend in Omaha, Neb., an interview with **Markel** (NYSE: MRK) management, breakfast at **First American** (NYSE: FAF) headquarters, the Value Investing Congress in Los Angeles, and The Motley Fool's annual staff meeting in Hershey, Pa. As usual, the people — especially the Fools — I met were the highlight of my travels. There were too many to mention them all, but a few stand out — **TMFRoZany** (Ro Calvet), **adumortier** (Alex Dumortier), **mungerman**, **WBuffettJr (**Rick Casterline), and **BBQPorkMogul**. Notes from the Berkshire Hathaway press conference and shareholder meeting and my trip to First American are up on the *Inside Value* website now. Look for the Markel interview transcript to be up shortly.

The Berkshire Meeting

The annual Berkshire Hathaway shareholders meeting is often referred to as "Woodstock for Capitalists," but it is much more than that. Warren Buffett and his longtime partner, Charlie Munger, hold court in front of 24,000 shareholders at the Qwest Center in Omaha. They answer unscripted questions for five hours — some related to Berkshire, but many about investing and life in general. What a contrast to the atmosphere at **Home Depot**'s (NYSE: HD) recent shareholders meeting, where directors did not bother to show up and shareholder questions were ignored by CEO Bob Nardelli!

The big buzz in Omaha this year was the acquisition of 80% of private Israeli metalworking tools manufacturer Iscar. Other topics of interest were succession planning at Berkshire and the commodity and real estate bubbles. Succession planning is perhaps more important at Berkshire than at most companies because much of the company's success is due to the capital allocation decisions of Buffett (75) and Munger (82) and the standards they have set for the company's culture. Buffett said that three current Berkshire executives have been identified by the board as capable successors should he die tomorrow. However, since he plans to live to 112, he joked, the names may change in the meantime. It is obviously crucial to Buffett that his successor maintains the culture.

Munger and Buffett were quite amusing when answering questions on the real estate and commodity bubbles. Buffett likened commodity speculators to Cinderella at the ball — the party gets wilder and wilder and everyone thinks they will get out before midnight. The trouble is that Cinderella has no watch, and there are no clocks on the wall.

It doesn't matter what the asset class or the industry, investors almost always pile into hot sectors after most of the money has already been made. Those nice upwardly mobile price charts seem to give comfort and proof of a good investment. Value investors, on the other hand, tend to look at what's not hot for their ideas. Sure, we may buy too early, but with a disciplined strategy and the patience to wait for the market to catch up to our valuation, we win over the long term.

Foolishly,

Philip Durell

MasterCard

Value Pick by Philip Durell

Investment Thesis

NYSE: MA	
www.mastercard.com	
Ph: 914-249-2000	
Recent Price: $46.62	
Intrinsic Value: $66.00	
Risk: High	

Buy Below: $50.00

MasterCard (NYSE: MA) had its initial public offering (IPO) in late May, but despite a 20% rise in the share price, I believe that the shares are still significantly undervalued. This stock does not come without risk, as the company faces litigation and likely judgments against it. The size of possible awards could be substantial, and it is this uncertainty that is providing us with an opportunity. Other positives for MasterCard include:

» Extremely strong brand that the company continues to invest in through its "priceless" campaign and sponsorship of worldwide events such as the FIFA World Cup of Soccer.

» Fabulous business model based on collecting a very small fee on billions of card transactions. The business is scalable with minimal capital expenditures or increase in variable expenses.

» According to recent reports by Global Insight and Nilson, all forms of worldwide electronic payment transactions are forecast to grow at around 13% over the next five years.

» Increasing percentage of total revenues from international sources lessens the dependence on the U.S. economy and consumers.

The Business

Contrary to popular belief, MasterCard itself does not make money charging merchants a percentage of the dollar transaction value or from high interest on outstanding consumer credit card balances — that's how the card-issuing banks make money. MasterCard makes its dough from transaction processing and by charging financial institutions an assessment for the use of the MasterCard brand name.

Transaction processing revenue is fee-based and depends on how often a MasterCard credit card is swiped — it's a true toll business that stands to grow at least in line with worldwide card growth, even if MasterCard does not increase market share. Assessment revenue is based on the amount charged. Every time a consumer charges a purchase, financial institutions pay MasterCard a very small percentage of the gross dollar amount. As consumer spending rises, MasterCard's cut increases. In the recent past, the percentage of total revenue from transactions has been increasing, as has the percentage of revenue coming from foreign countries.

	2003	2004	2005	2006 Q1
Transactions	64%	63%	66%	67%
Assessments	36%	37%	34%	33%
International	37%	42%	45%	47%

Source: MasterCard SEC filings

In addition to the ubiquitous MasterCard-branded credit cards, the company has MasterCard, Maestro, and Cirrus debit cards, the Maestro ATM network, and stored value programs such as prepaid cards and traveler's cheques. The company also makes money from currency conversion transactions.

The company has a three-point strategy for driving the business:

» Increase the categories of merchants who accept cards. Examples include touchless cards for fast food retailers and public sector payments such as taxes, fees, fines, and tolls.

» Increase payment channels. A good example is the payment of recurring bills like cable or telephone.

» Global sponsorship arrangements with selected merchants who receive incentives to promote the use of MasterCard-branded programs.

In addition to the very successful "priceless" marketing campaign, the company sponsors a wide variety of popular sports including soccer with the FIFA World Cup and European Champions League, several golf tours, Major League Baseball, the National Hockey League, and several football teams.

As a result of the May 25 IPO, the company now has 135 million shares; 49% are available on the open market, 41% are owned by the original owners (banks), and 10% will be transferred to the MasterCard Foundation, which is to

Financial Snapshot

(All dollar amounts are in millions except earnings per share.)

	FY03	FY04	TTM
Total Revenue	$2,231	$2,593	$3,018
Earnings Per Share*	($2.86)	$1.76	$2.22
P/E Ratio	N/A	N/A	21.1*
P/B Ratio	N/A	N/A	3.6*
Dividend Yield	N/A	N/A	N/A
Total Debt	$230	$230	$230
Total Cash + Investments	$911	$1,137	$1,307
Return on Equity	(45.4%)	28.4%	25.6%
Return on Assets	4.0%	7.6%	9.0%

*Adjusted for new share structure.

be set up as a charitable organization. The original owners have Class B shares, which have no voting rights, although they will still appoint three directors to the board. The Class A common shares will have 83% of the voting rights, and the foundation will have 17% if the over-allotment option is fully exercised. Because the foundation will be a separate entity, it necessitates a large write-down, which will affect the income statement and balance sheet. This will result in negative earnings for 2006, although the cash flow will not be affected much.

Competitive Landscape

MasterCard's biggest competitor is privately held **Visa International**, which has approximately double MasterCard's annual revenue. These two dominate the card landscape, although **American Express** (NYSE: AXP) and **Morgan Stanley**'s (NYSE: MS) Discover cards will be increasingly competitive in the United States now that rules forbidding banks to issue competing cards to MasterCard and Visa have been struck down by the U.S. Department of Justice. Internationally, there are many competing national and regional cards, but none have the global reach of Visa or MasterCard. MasterCard also competes with card processors **First Data** (NYSE: FDC) and **Total System Services** (NYSE: TSS).

There's a fierce battle at the top of this market, both in courting consumers and in the courts. MasterCard is suing Visa over a bylaw that essentially imposes an onerous "settlement fee" on its 100 largest customers if they switch their debit cards to MasterCard. A decision in MasterCard's favor would be a big boost because debit cards are growing faster than credit cards and Visa holds a much bigger share of the market.

The Valuation

Although MasterCard's IPO took place just weeks ago, it has filed SEC annual reports giving us the past five years of financial statements. Over that time, revenues have grown at a compound annual average of 15.2%, and net income at 17.7%. Capital expenditures have generally been declining because the system requires few expenditures to maintain once it is set up. The company estimates that current peak day usage is just 70% of transaction capacity, and data centers and systems are easily scalable. Consequently, cash produced has been outstanding.

The one problem for MasterCard is the cash outflows from past settlements and potential future cash outlays that may result from ongoing litigation. A 2003 merchant settlement is on the books as a $615 million liability. This is the discounted value of $100 million in annual payments that have to be made every December until 2012. I estimate that each $1 billion in possible future settlements would reduce the value by approximately $6 per share, and I think it likely that such awards could total between $1 billion and $2 billion. Fortunately, the company currently has $1.3 billion in cash and short-term investments on the books and will retain an additional $650 million from the IPO.

The global electronic payments market is expected to grow at around 13% per annum over the next five years, and MasterCard is well-positioned to benefit. I've estimated 10% revenue growth. I chose a lower growth rate than the current expectations because of competitive pressures from rivals, merchants, and banks. The company has recently updated all of its systems and data centers, and I expect selling, general, and administrative costs to grow at a lower rate. The operating profit margin is currently 16.6%, and I expect it to grow to around 21% by 2014 because of the scalability inherent in the company's business model. At that rate, earnings could grow at around 15% per annum, but I've adjusted that slightly lower to account for ongoing competitive risks. I value MasterCard at $66 per share and would purchase shares under $50.

The Risks

American Express and Discover are seeking damages as a result of MasterCard's former Competitive Programs Policy (and a similar Visa rule) that prohibited financial institutions from issuing competing cards. Damages or an out-of-court settlement could be substantial because this comes under antitrust law. Another risk is that MasterCard could lose market share to American Express and/or Discover now that banks are allowed to issue these cards. The company is subject to other class action litigation, including actions against its currency conversion practices, for which the company has already established an $89 million reserve.

Interchange fees are under significant regulatory and legal challenges, and although MasterCard does not receive revenue from them, the company does maintain standard interchange fees for its banking clients. A reduction in them could cause banks to seek alternative processing systems or squeeze MasterCard for bigger rebates. Consolidation among banks and large retailers is likely to give them more bargaining power when it comes to transaction fees.

Regulatory changes could increase compliance costs for the company. This includes anti-money laundering, consumer privacy, and data security.

Finally, the company guarantees MasterCard payments. A failure by one of its bank partners would leave the company liable. To counteract this, the company monitors risk closely.

Conclusions

MasterCard faces several challenges, but the underlying business and brand strength put the company in an excellent position to take advantage of long-term trends away from paper to electronic payment transactions. The company earns a high risk rating because the share price is likely to be quite volatile as it reacts to news concerning the various lawsuits. This one is for patient investors who can stomach the share price volatility that may ensue. I also highly recommend buying no more than a third of a position — there could be future opportunities to buy at a lower price.

Amerigroup

Value Pick by Charly Travers

Investment Thesis

NYSE: AGP	
www.amerigroupcorp.com	
Ph: 757-490-6900	
Recent Price: $30.00	
Intrinsic Value: $41.00	
Risk: High	

Buy Below: $33.00

Amerigroup (NYSE: AGP) is a small managed-care company dedicated to providing health-care services to low-income Americans. Its core member base is young mothers and children who are eligible for Medicaid. The company's performance in this niche market has been phenomenal. Over the past five years, compound annual net income growth is in excess of 20%. I think Amerigroup's future looks bright with significant growth opportunities ahead of it — consider that it is only operating in 10 states and last year was its first in the federal Medicare program.

The company took a hit last year when it turned in an abysmal third quarter, missing earnings per share estimates by $0.52. The company's health-care expenses far exceeded its internal projections. Because of this misstep, 2005 EPS came in at $1.02, which was far lower than the company's guidance of $1.73. As you may imagine, the stock took an absolute beating, shedding nearly two-thirds of its value. It has since recovered markedly due to a strong first quarter, but it is far below its highs and I think it remains significantly undervalued. Also working in our favor:

» The Congressional Budget Office is forecasting Medicaid expenses to double over the next decade. Amerigroup is in a strong position to participate in this growth.

» The balance sheet is very strong and the company has a lot of financial flexibility.

» The company has excelled while historically operating in just a few states. It has a significant opportunity to grow its business organically by expanding into new states and is taking measured steps in this direction. It began operations in three new states during 2005 and is taking a substantial step into Georgia this year, a move that will be the company's single largest expansion in its history.

» I believe that Amerigroup is an attractive acquisition candidate, and I would not be the least surprised if a larger company buys it out in the next few years since this is an industry in consolidation.

The Business

Amerigroup was founded in 1994 by Jeffrey McWaters, who still serves as CEO and chairman of the board of directors. I love to see entrepreneurs leading the companies they have founded because they are typically committed to creating real value for shareholders, not catering to the whims of Wall Street. So far, McWaters' long-term track record has been stellar. Amerigroup's revenue has grown from a paltry $67 million in 1997 to more than $2.3 billion last year.

The company's recipe for success lies in its focus on serving low-income populations via government-sponsored health-care programs like Medicaid, SCHIP, and FamilyCare. These are generally programs for people who do not have insurance through their employer and cannot afford private health insurance. Unlike many other health-care companies, it does not try to provide services to the general population. The company contracts with the Medicaid programs in 10 states and the District of Columbia. Though Amerigroup is a small company, in the regions in which it operates, it tends to have some of the largest Medicaid coverage memberships.

Amerigroup stumbled badly last year when third-quarter expenses skyrocketed out of control, causing the company to miss its earnings guidance badly. Not only did this event underscore the unpredictability of this business, it also called management's competence into question. This shock was serious enough to drop the stock from $46 to $15 a share.

It's important to go into more detail on exactly what happened. The company reviewed its medical costs over this period and found that more of its members needed health-care services than its actuaries could have predicted based upon previous years. Particularly important is that these were very expensive services, such as neonatal intensive care.

I'm not surprised that such an event could occur. After all, models used to forecast expenses are just providing estimates — it's a bit like trying to predict the weather. Real outcomes will occur that fall outside of what was predicted.

That said, I do like management to have some idea of what is going to happen with its business. So I'm pleased to see that Amerigroup has enhanced its medical liability estimation processes. This gives me some comfort that such a massive earnings miss will be a rare event, though obviously I can't guarantee that everything will be smooth sailing ahead.

Now that the stock has recovered to $30, it's fair to

Financial Snapshot

(All dollar amounts are in millions except earnings per share.)

	FY04	FY05	TTM*
Total Revenue	$1,824	$2,330	$2,446
Earnings Per Share	$1.66	$1.02	$1.34
P/E Ratio	16.7	20.5	20.1
P/B Ratio	2.6	2.8	1.8
Dividend Yield	N/A	N/A	N/A
Total Debt	$0	$0	$0
Total Cash + Investments	$650	$644	$795
Return on Equity	16.7%	8.9%	11.0%
Return on Assets	10.2%	5.4%	6.6%

*As of March 31, 2006.

wonder if we have missed the boat. I don't think we have. Though the stock has now doubled off of its low, it remains far below its 52-week high. While it would have been nice to participate in some of those gains from the bottom, doing so would have entailed taking on a lot more risk. Specifically, we would have had no clue if management would be able to get its house in order with respect to controlling its expenses. With two solid quarters under its belt since the debacle and the hiring of a new CFO, I feel confident that Amerigroup is back on track and that we are getting this company at a significant discount to its intrinsic value.

Competitive Landscape

Amerigroup contends with much larger competitors like **Wellpoint** (NYSE: WLP) and **Humana** (NYSE: HUM). Just because Amerigroup is smaller does not put it at a disadvantage. Even though health insurance is a business where scale matters, historically Amerigroup has done quite well and I see no reason why that trend would reverse. The competition can vary quite a bit from state to state depending on which insurers have been awarded the Medicaid contracts. I don't spend much time worrying about Amerigroup's ability to operate in an environment that contains much larger insurers. After all, Amerigroup has been able to grow its top line more than 30-fold in the past decade with these same competitive threats. I also feel that any big fish eyeing Amerigroup's markets would be more likely to just buy the company outright.

The Valuation

Amerigroup has a long track record of turning in solid double-digit growth. Yet the market is currently valuing this company as if it will only grow about 4% to 5% a year in perpetuity. I think that's a gross underestimation given the company's history and the growth opportunities lying ahead. Additionally, the Centers for Medicare and Medicaid Services expects U.S. health-care spending to increase at an average annual rate of 7.1% through 2014.

I took a rolling average of Amerigroup's cash acquisition costs, capital expenditures, and changes in reserve liability to arrive at an adjusted trailing-12-month free cash flow (FCF) of $120 million. I assume that the company will be able to grow FCF at 10% for each of the first five years, 7% annually for years six through 10, 4% per year for years 11 through 20, with a 3% terminal growth rate. I used a discount rate of 12%. That gives us an intrinsic value of $41.

I think the growth assumptions err on the conservative side — as they should — but at the same time, if Amerigroup can grow at its historical rates for the next few years, it should blow my intrinsic value estimate out of the water.

The Risks

As we can see from what happened to Amerigroup in the third quarter of last year, the health-care business can be a bit unpredictable. If the company cannot accurately forecast its health-care expenditures, it will not be able to adjust its premiums accordingly and we could get hit with another earnings surprise of the unpleasant variety.

The company relies on states to renew its Medicaid contracts. Many of its contracts are short term in nature and are subject to annual renewals. A lot of them come up for renewal in mid-2006. There are no guarantees that these contracts will be renewed on favorable terms — or even renewed at all — and the loss of a contract could have a material impact on the company's revenues. The company is also exposed to federal and state Medicaid funding changes. Budgetary pressures could freeze Medicaid spending, which would hurt Amerigroup's growth and squeeze its margins.

Amerigroup is operating in a highly regulated industry. Several states have requirements on how much the company must spend on health-care expenses as a percentage of its premiums. Texas even goes so far as to require the company to pay a rebate if its profits exceed established levels. While I can't say this is an appealing part of Amerigroup's business, it's the nature of the beast when the company's business model is predicated upon catering to individuals enrolled in government health programs.

Conclusions

Over the past decade, Amerigroup has proved itself to be a high-quality business. Year after year, the company has turned in solid growth as it matured from a small startup to a major player in a number o f large health-care markets. Yes, the company hit a bit of a roadblock last year when its internal estimates of health-care expenses were way off the mark, but I view this as a one-time event that has since been adequately addressed. Amerigroup has brought on a new CFO, James Truess, who has 16 years of finance experience in the industry, the last nine of which were as the CFO of Group Health Cooperative. It's a smart move, particularly in light of the company's recent troubles.

Amerigroup is a very solid company and due to what I believe is a one-time event, we are able to get shares at a discount. This is a small-cap company operating in a risky environment, so the share price will be volatile. While I am not concerned, I mention it because some investors are not comfortable owning stocks that can fluctuate significantly. I am recommending a buy-below price of $33 — 20% below my intrinsic value estimate of $41.

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Valuable Knowledge: Stock Splits

by Philip Durell

In the May mid-month update, I noted that **Intuit** (Nasdaq: INTU) had announced a two-for-one stock split effective July 6 (shares begin trading at the new price on July 7) for shareholders of record as of June 21.

What Is a Stock Split?

A stock split is a deliberate action by a company to increase the liquidity of its shares. The most common splits are two for one and three for two, but the split can be any ratio the company chooses. Some investors view a stock split as a bullish sign, believing it indicates that management is confident that the price will keep rising. In practice, there is often a pop in the share price immediately after the announcement of a coming split, but there is no evidence to suggest that this increase is permanent.

The most common reason for a stock split is to keep the share price in an "affordable" range because many investors prefer lower share prices. This is purely psychological, yet I often have difficulty persuading some of my friends that an $80 stock is not expensive! In the United States, the "affordable" range seems to be below $50. In the United Kingdom, stock prices are traditionally quoted in pennies because U.K. investors are used to the lower prices. Few U.K. companies trade at a higher price than 1,000p ($18.80). For example, **Vodafone** (NYSE: VOD) trades in London at 119.75p, which at today's exchange rate is $2.23. American investors would consider this a penny stock, and many mutual funds would ignore the shares. Vodafone's solution is to set its American Depositary Receipts for the U.S. market as equal to 10 U.K. shares.

It is important to note that there is absolutely no change in the company's fundamental valuation, or in the value of the shares held by an individual investor as a result of a share split.

It is important to note that there is absolutely no change in the company's fundamental valuation, or in the value of the shares held by an individual investor as a result of a share split. Let's look at Intuit as an example:

- **Recent share price:** $54.30
- **Shares outstanding:** 174.11 million
- **Market capitalization:** $9,450 million

Assuming that there is no change in the share price, on July 7, these figures will be:

- **Share price:** $27.15
- **Shares outstanding:** 348.22 million
- **Market capitalization:** $9,450 million

If you as an individual shareholder currently own 100 shares of Intuit at $54.30 per share, then on July 7 your holding should appear in your brokerage account as 200 shares at $27.15. This again assumes no share price change between now and then. If you buy shares between the record date on June 21 and July 6, you will still receive your split on June 7. In this case, the seller has an obligation to deliver the share dividend to you. The effective ex-dividend date for a share dividend is usually one day after the payout date.

Intuit does not pay a cash dividend, but if it did, the dividend per share would be reduced by the same percentage as the share price, in this case 50%. The dollar amount received would be exactly the same as if the split had not occurred. About the only benefit I can think of for a small shareholder is in the reinvestment of dividends through a brokerage account that allows only whole shares to be reinvested. Let's look at another example.

Say you own 200 shares in ABC Company at $60 per share. The company pays a quarterly dividend of $0.50 per share, so you receive $100. Your broker will buy you one additional share and deposit the remaining $40 in your account. The company then does a two-for-one stock split, and as a result, you now have 400 shares at $30 per share, and the quarterly dividend is $0.25 per share. On the next dividend payment date, your broker will now buy you three additional shares and deposit the remaining $10 in your account. In the long term, you benefit slightly from having more money reinvested and less cash deposited. If your brokerage allows partial share purchases, then the stock split confers no additional advantage whatsoever.

Reverse Splits

Sometimes a company will do a reverse split to bolster the price of its shares and give them more visibility to investors who don't buy lower-priced shares. It usually occurs after a large decline in the company's share price, and it is no guarantee that the price will not continue falling — in fact, a reverse split is often at least a yellow flag to many investors because it is generally a cosmetic exercise.

Philip's Watch List

This Watch List features some companies Philip has researched and that interest him as potential investments. They are not formal recommendations.

Legg Mason

NYSE: LM	
Stock Price:	$96.91
Market Cap (millions):	$13,510
P/E:	11.0
P/B:	2.1
Yield:	0.8%

Asset management company **Legg Mason** (NYSE: LM) (home of famed value investor Bill Miller) is suffering a bout of indigestion after recently swallowing **Citigroup**'s (NYSE: C) asset management business. (Citigroup got Legg Mason's brokerage and capital markets businesses.) The deal doubled Legg Mason's assets under management and should prove to be an excellent long-term acquisition. In the meantime, the shares have dropped by more than $40 since late February. Apart from integration risk, the company could face fund withdrawals in a downward market.

Zebra Technologies

Nasdaq: ZBRA	
Stock Price:	$34.95
Market Cap (millions):	$2,470
P/E:	22.4
P/B:	2.8
Yield:	N/A

Specialty printer designer and manufacturer **Zebra Technologies** (Nasdaq: ZBRA) makes the Watch List courtesy of *Inside Value* team member Jean Graham. The company has experienced a year of flat sales growth, delayed product rollouts, adverse currency exchange, and comparisons to a stellar 2004. For the coming year, the company has some new retail accounts and should benefit from the wide adoption of radio frequency identification (RFID). In addition, the currency exchange rates have reversed (dollar is weaker), and most of its operational problems are fixable. I'll be watching for further evidence of a turnaround.

Ask the Advisor

by Jean Graham

Q: What is the LIFO adjustment (reserve) and how is it used to value inventories?

A: Companies account for the cost of inventory in several ways. The most common are last in, first out (LIFO) and first in, first out (FIFO). The relationship described below assumes a period of generally rising prices and/or inflation, which over the longer term is a more common occurrence.

If the company uses FIFO:

- Cost of goods sold (COGS) may be lower because it is using items that have a lower cost.
- Under the aforementioned assumptions, gross earnings will be higher since costs are lower.
- Provision for taxes (on GAAP-reported financials) on the income statement will be higher on the greater profit decreasing net income and cash flow.
- FIFO will create higher values for inventory because these values represent inventory purchased at lower prices with lower costs.

If LIFO is used:

- COGS will be higher.
- Earnings and taxes will be lower.
- Since expenses and earnings are more closely matched, there should be a smoother earnings stream.
- LIFO can underestimate the value of retained inventory on the balance sheet in an inflationary economy. The inventory left on the balance sheet is lower in value due to the higher costs charged by using the more expensive products to fill orders.

If you are analyzing company performance LIFO may:

- Reduce working capital (current assets minus current liabilities).
- Increase inventory turnover (COGS/average inventory).
- Lower inventory days (inventory/COGS/365).
- Lower gross profit.
- Lower stockholders equity.

When analyzing companies in a period of generally rising prices, investors should be aware that the narrower margins due to LIFO accounting may make the company appear to have lower returns on invested capital, equity, and assets when compared to FIFO companies.

LIFO Reserve

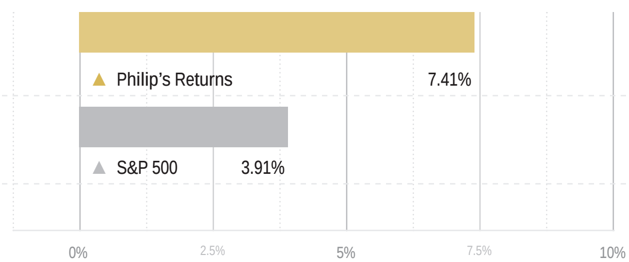
A LIFO reserve serves as an indicator of the net difference between inventory values if FIFO accounting were used relative to LIFO. Investors can add the LIFO reserve to balance sheet inventory to see how much inventory would be worth if FIFO accounting had been used. (COGS can be adjusted to FIFO by looking at the net difference between LIFO reserves over a given period.)

So why bother with all this? When analyzing companies, knowing which method is used will help investors neutralize the effects of accounting conventions, creating more of an apples-to-apples comparison.

SCORECARD

Details on all recommendations available at InsideValue.Fool.com

AVERAGE RETURNS



Since inception, includes sold positions.

MOST RECENT RECOMMENDATIONS

	Issue	Company	Ticker		Company	Ticker
▸	07/06	MasterCard	MA	&	Amerigroup	AGP
▸	06/06	UnitedHealth	UNH	&	Microsoft	MSFT
▸	05/06	Symantec	SYMC	&	Wal-Mart	WMT
▸	04/06	Intel	INTC	&	First American	FAF
▸	03/06	Dell	DELL	&	3M	MMM
▸	02/06	Mittal Steel	MT	&	Dell	DELL

BAGGERS & LAGGERS

TOP 5 PERFORMERS

▲ **41.4%**
First American (FAF)*
Issue: 10/04

▲ **37.8%**
Intuit (INTU)
Issue: 03/05

▲ **34.9%**
Rent-A-Center (RCII)
Issue: 11/05

▲ **32.2%**
Colgate-Palmolive (CL)
Issue: 12/04

▲ **21.0%**
Lloyds TSB (LYG)
Issue: 11/04

BOTTOM 5 PERFORMERS

▼ **(30.0%)**
Fannie Mae (FNM)
Issue: 01/05

▼ **(24.0%)**
Cendant (CD)
Issue: 02/05

▼ **(19.9%)**
Dell (DELL)*
Issue: 03/06

▼ **(14.2%)**
Intel (INTC)
Issue: 04/06

▼ **(11.1%)**
Vodafone (VOD)
Issue: 07/05

*Excluding sold positions. * FAF was also recommended in the 04/06 issue, DELL was also recommended in the 02/06 issue. This is not an endorsement to buy any of these stocks. It is simply a snapshot of our companies' performance to date.*

BEST RECOMMENDATIONS FOR NEW MONEY NOW

BRAVO (BEST RISK-ADJUSTED VALUES)

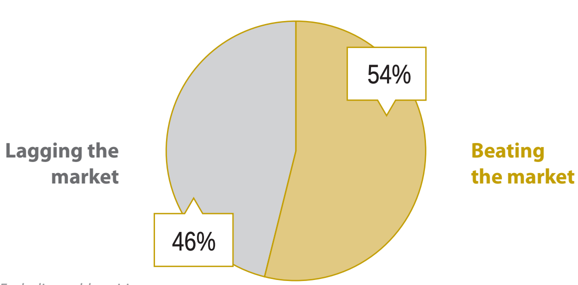
	Issue	Company	Ticker	Buy Below
▸	11/05, 06/06	Microsoft	MSFT	$27.00
▸	04/05, 09/05	Anheuser-Busch	BUD	$48.00
▸	05/06	Wal-Mart	WMT	$50.00
▸	02/06, 03/06	Dell	DELL	$28.50
▸	06/05	Home Depot	HD	$40.00

PURE (POTENTIAL UPSIDE, RISK EXCLUDED)

	Issue	Company	Ticker	Buy Below
▸	01/05	Fannie Mae	FNM	$54.00
▸	11/05, 06/06	Microsoft	MSFT	$27.00
▸	10/04, 04/06	First American	FAF	$44.00
▸	02/05	Cendant	CD	$18.50
▸	04/06	Intel	INTC	$22.00

We consider this issue's recommendations to be the best opportunities for new money now. We do not include them in these rankings in order to give you a broader range of possible investments.

RECOMMENDATION REPORT CARD



Excluding sold positions.

WHAT'S IT ALL ABOUT?

This week's BRAVO list is again dominated by large-cap stocks, which continue to provide excellent value. Federated Investors (NYSE: FII), Coca-Cola (NYSE: KO), and First Data (NYSE: FDC) only just missed the top five. Microsoft is also featured on the PURE list, which indicates that it's a great value right now.

As I mentioned last month, Fannie Mae (NYSE: FNM) is still in the high-risk category as the company is still in the process of restating financials, but I continue to believe that the upside potential is there. Cendant (NYSE: CD) appears on the PURE list, but don't forget that the company intends to split into three separate companies after selling off its online travel business. I would avoid Cendant if you are buying a small number of shares.

All scorecard data as of market close 06/09/06