

INVESTING



Ugly Stocks, Great Opportunities

[By Tim Hanson]

Value investing is one of the most successful money-making strategies in the market. Master investor Warren Buffett, for example, has earned annualized returns of more than 20% for the past 40 years by buying good companies when they're cheap.

Unfortunately, companies often get cheap for a reason: Something may be wrong with them.

The ugly

One of Buffett's best investments was taking a major stake in **Coca-Cola** in the fall of 1988 - in the aftermath of 1987's Black Monday crash, when most analysts thought Coke's growth prospects looked dim.

Since 1988, Buffett's investment in Coke has earned annualized returns of approximately 14%. That's both impressive and market-beating. Yet analysts today continue to doubt the brand's power and growth prospects.

Will Coke stay down for the count this time? *Motley Fool Inside Value* lead analyst Philip Durell doesn't think so. He recommended the company to subscribers in the January 2005 issue for many of the same reasons Buffett bought in 1988. Coke's situation is just ugly enough to get you a great price on a good company.

The same could also be said for the public-relations difficulties facing **Wal-Mart**, the slowdown in listings and insider selling that has investors suspicious of **eBay** (Nasdaq:

EBAY), the glut of hotel rooms in Macau that has hurt the outlook for **Las Vegas Sands** (NYSE: LVS), the FTC regulation that has hampered **Whole Foods** (Nasdaq: WFMI) acquisition of **Wild Oats** (Nasdaq: OATS) and hurt the stock in the process (good job and thanks very much, FTC), or the questionable foray by **Starbucks** (Nasdaq: SBUX) into cinema.

Although Coke's stock isn't firing on all cylinders right now, it is starting to come around. There are no illegalities, and CEO Neville Isdell is focused on spurring future growth. The returns should be solid from here.

When ugly is too ugly

But it can get pretty ugly out there on the market. Master small-cap investor David Nierenberg has told Fool co-founder Tom Gardner that there are two clear indications that can help you avoid an ugly situation. First, "If we see an ethical blemish on the part of the incumbent management or the board, we are absolutely *not* interested. The second is: If we cannot trust or understand their accounting, we are absolutely *not* interested."

Krispy Kreme Doughnuts (NYSE: KKD) is one stock Nierenberg was avoiding when Tom interviewed him in 2005. Although new management was trying to turn around the business, the company had not yet released any new, reliable 10-Ks or 10-Qs. (It did so in April 2006.) As Nierenberg wondered to Tom before those releases, "[Has] this company ever earned a real profit? And what return on invested capital has it actually made at the newly opened stores?" Without answers to those questions, it was impossible to determine in 2005 at what price Krispy Kreme was a value - if any.

Fool's final word

When you're trolling for values in the market, you'll find some ugly situations. Without reliable management and financials, you should consider the situation too ugly for your dollars.

Separating the ugly from the *too* ugly can be tricky. If you'd like some help, consider a 30-day free trial to *Motley Fool Inside Value*. Philip specializes in finding ugly situations ripe for a profitable turnaround - whether it's because of new management, new strategies, or new events. [Click here](#) to learn more.

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Tim Hanson owns shares of Whole Foods and would like to again congratulate the FTC for bringing and building a water-tight case

against the Whole Foods-Wild Oats merger. Coca-Cola and Wal-Mart are Inside Value picks. eBay, Whole Foods, and Starbucks are Motley Fool Stock Advisor recommendations. No Fool is too cool for disclosure.

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