

23 October 2007

Active Voice: Mid Cap

Key Exhibits

High vs. Low Quality Sector Performance, pg 2

Industrials Foreign Exposure, pg 3

Industrials: Energy-related vs. Construction-sensitive Performance, pg 4

Mid Cap Industrials Quality Metrics, pg 5

Market Price Performance

As of 22 October	% Change	
	YTD	Since Jan '06
Cirrus MSX Industrials	30.7	55.8
Cirrus Mid Cap Industrials	37.6	63.0
Cirrus Small Cap Industrials	22.6	49.7
Cirrus Micro Cap Industrials	18.3	34.2
S&P 500 Industrials	11.3	25.6
S&P Mid Cap Industrials	22.6	36.9
S&P Small Cap Industrials	14.3	34.3
Ind. Select Sector SPDR Fund	14.4	27.5
iShares DJ US Ind. Sector Fund	14.3	27.9
Vanguard ETF Industrials	15.6	31.7
PowerShares Dyn. Ind. Port.	18.3	---
Rydex ETF S&P Eq. Wt. Ind.	14.6	---
iShares S&P Global Ind. Fund	17.8	---
Wisdom Tree Intl Ind. Fund	6.1	---

Valuation levels and high earnings expectations of industrial-based stocks force a selective posture. Three themes to isolate and leverage within the Industrial sector: High Quality, Foreign Exposure and Energy-related Spending.

Trade Ideas

■ #1: Quality. Growth managers buy Quality, not Cyclical, right?

Adopt a quality bias among Industrials as the Industrial run gets into its later stages. A relative value basket that is long higher quality over lower quality industrial names allows one to maintain exposure and yet mitigate some of the valuation/cyclicality risk that can accompany this sector.

■ #2: Foreign Exposure & Industrials – It’s all about China.

Long a basket of Industrials with high foreign revenue exposure. Such firms are likely to benefit from global industrial spending and a weakening dollar.

■ #3: Energy-related Industrials lead Construction-sensitive Industrials.

Long a basket of Industrials likely to benefit from increased industrial spending tied to rising energy costs. Short a basket of Construction-related Industrials to limit the downside from the on-going downturn of the housing sector.

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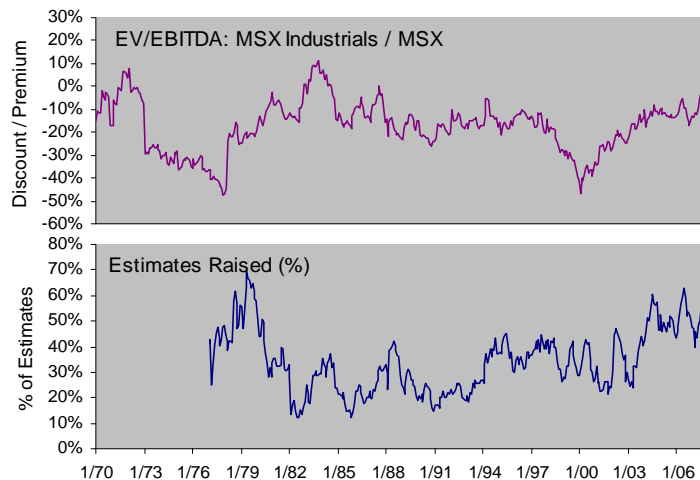
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Fig 1: High valuation levels and lofty earnings forecasts among Industrial stocks force selectivity.



Source: Cirrus Research, I/B/E/S

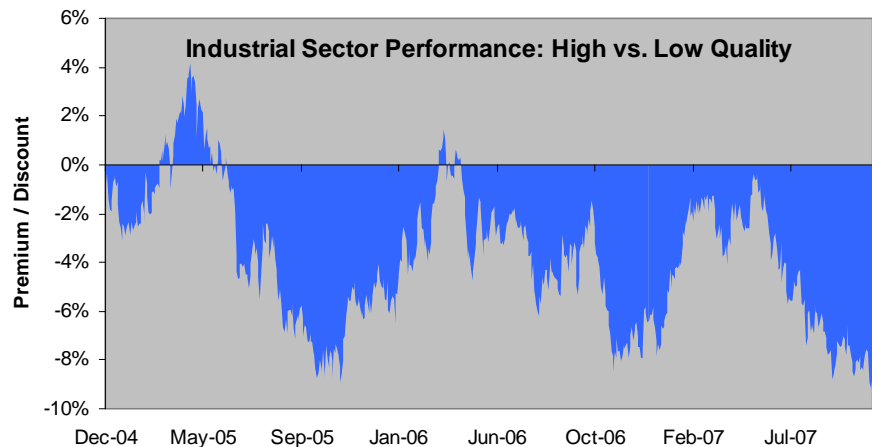
Quality – Growth managers always buy Quality, not Cyclical, right?

Trade Idea: Adopt a quality bias among Industrials as the Industrial run gets into its later stages. A relative value basket that is long higher quality over lower quality industrial names allows one to maintain exposure and yet mitigate some of the valuation/cyclicality risk that can accompany this sector.

As a penchant for conservative investments and visible earnings becomes more prevalent, a higher quality bias can only become a dominant trait among Industrials. While it appears that market participants continue to chase after cyclicality, we see the Industrial sector evolving from a pure cyclical to “growth cyclical.” The incremental buyer of this sector may be the “high quality growth” manager. Furthermore, a quality bias seems appropriate as growth and quality-growth managers pay greater attention to the Industrial sector. Additionally, continuing concern over consumer credit underscores a broad market-based quality bias.

Figure 2 relates a simple performance spread between higher quality and lower quality industrials. The term “quality” is captured here via a simple combination of Return on Equity, Leverage (Debt to Total Capital), Size (Market Capitalization) and Earnings Dispersion (standard deviation of estimates divided by mean consensus estimate for the current year). Higher quality industrials have underperformed lower quality by almost 10% in just a few months.

Fig 2: The rush to lower quality Industrials appears in vogue. High sector valuations could easily reverse the low-quality bias.



Source: Cirrus Research

Mid Cap Industrials: Quality Rankings		Mkt Value
Aerospace & Defense		
Goodrich Corp.	GR	7,910
L-3 Communications	LLL	12,060
Alliant Techsystems Inc.	ATK	3,538
Building Products		
American Standard Cos.	ASD	7,510
Armstrong World Indus.	AWI	2,381
Owens Corning Inc	OC	3,265
Const. & Engineering		
Jacobs Engineering Grp	JEC	7,925
Fluor Corp.	FLR	11,229
Foster Wheeler Ltd.	FWLT	8,443
Elec. Comp. & Equip.		
Cooper Industries Inc.	CBE	9,400
Ametek Inc.	AME	4,281
Hubbell Inc. (CI B)	HUB.B	3,213
Multi-Industry		
Carlisle Cos.	CSL	3,060
Teleflex Inc.	TFX	3,063
Leucadia National Corp.	LUK	9,614
Const. Machinery		
Joy Global Inc.	JOYG	4,688
Manitowoc Co.	MTW	4,986
Terex Corp.	TEX	8,140
Farm Machinery		
AGCO Corp.	AG	3,955
Heavy Trucks		
Cummins Inc.	CMI	11,866
Oshkosh Truck Corp.	OSK	4,294
Trinity Industries Inc.	TRN	3,047
Industrial Machinery		
Donaldson Co. Inc.	DCI	3,022
Harsco Corp.	HSC	4,685
Parker Hannifin Corp.	PH	12,484
Industrial Dist.		
W.W. Grainger Inc.	GWW	7,731
Fastenal Co.	FAST	6,867
Copart Inc.	CPRT	2,591

Foreign Exposure & Industrials – It's all about China

Trade Idea: Long a basket of Highly Foreign Exposed industrials to benefit from the global growth industrial spending trend and weak dollar and offset the domestic bias of small stocks.

China. Need we say more? The industrial demand trend in Asia will continue to dwarf US industrial spending over the next few years. Consistent with this is a bias to look to firms that have strong overseas exposure. Clearly, the weakening greenback can only exacerbate current trends. The relative performance curve, Figure 3, indicates that stocks with high foreign revenue exposure in the Industrial sector are dominant. Unless one can position on a strong US dollar, this high foreign exposure basket remains a crucial way to isolate Industrial sector leadership.

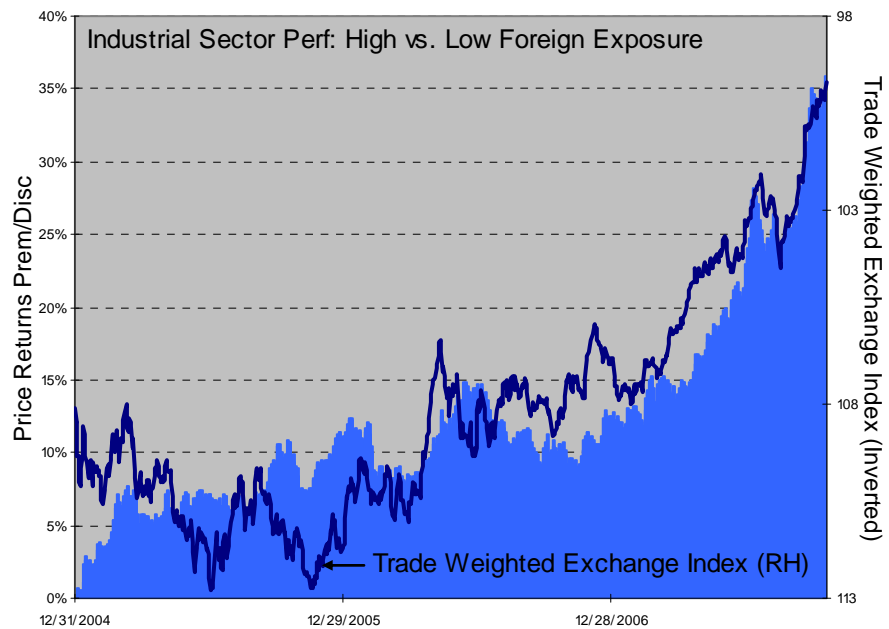
The basket of Industrial firms with high foreign revenue exposure (40% or greater sales outside the US) outperformed the basket of their lower exposed counterparts by roughly 35% since January 2005. Benefits of foreign revenue sources do not appear to be limited to firms with direct business in the Far East, but also our neighboring trading partners, Mexico and Canada.

Mid Cap: Top Foreign Sales Exposures

	Ticker	% Sales
Building Products		37%
American Standard	ASD	47%
Armstrong World Ind.	AWI	30%
Owens Corning Inc	OC	19%
Const. & Engineering		50%
KBR Inc.	KBR	86%
Foster Wheeler Ltd.	FWLT	80%
Fluor Corp.	FLR	55%
Elec. Comp. & Equip.		31%
Ametek Inc.	AME	48%
General Cable Corp.	BGC	44%
Thomas & Betts Corp.	TNB	34%
Multi-Industry		12%
Teleflex Inc.	TFX	57%
Carlisle Cos.	CSL	9%
Const. Machinery		54%
Terex Corp.	TEX	62%
Joy Global Inc.	JOYG	49%
Manitowoc Co.	MTW	48%
Heavy Trucks		37%
Cummins Inc.	CMI	50%
Oshkosh Truck Corp.	OSK	18%
Industrial Machinery		45%
Pall Corp.	PLL	64%
Harsco Corp.	HSC	62%
Flowserve Corp.	FLS	60%
Industrial Dist.		7%
Wesco Intl Inc.	WCC	13%
W.W. Grainger Inc.	GWW	12%
Fastenal Co.	FAST	7%
Mid Cap Industrials		38%

Source: Cirrus Research, Compustat

Fig 3: The Industrial build-up in Asia coupled with a plummeting US Dollar should continue to drive highly foreign exposed Industrial firms.



Source: Cirrus Research, Federal Reserve

Focus on Industrials that benefit from rising energy costs, not Housing/Construction

Trade Idea: Long a basket of Industrials likely to benefit from increased industrials spending tied to rising energy costs. Short a basket of Construction-related Industrials to limit the downside from the on-going downturn of the housing sector.

Mid Cap Industrials: Top Energy Exposures

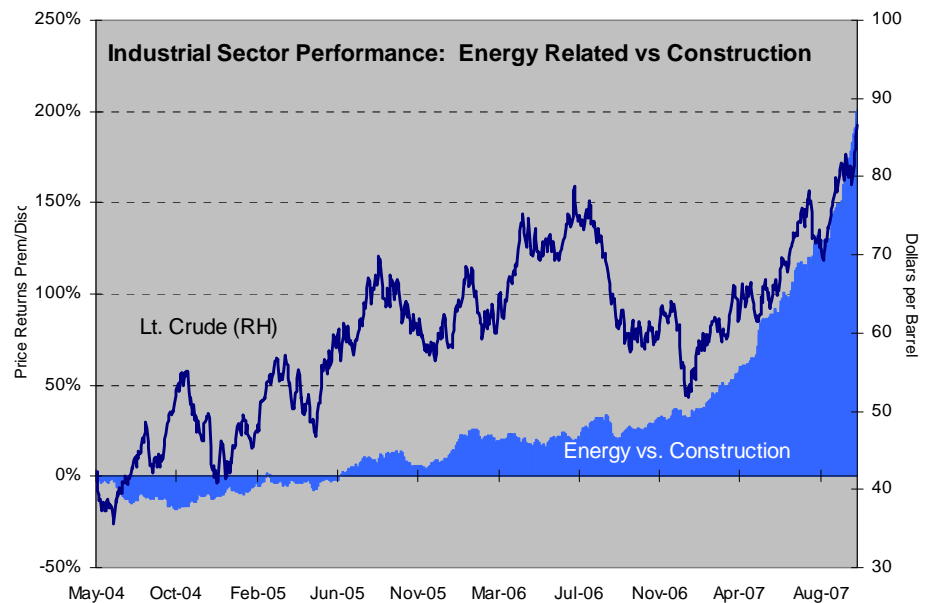
	Ticker	Mkt Cap
Const. & Engineering		
Fluor Corp.	FLR	11,229
Jacobs Eng. Group Inc.	JEC	7,925
KBR Inc.	KBR	5,548
Elec. Comp. & Equip.		
Roper Industries Inc.	ROP	5,606
Const. Machinery		
Joy Global Inc.	JOYG	4,688
Industrial Machinery		
SPX Corp.	SPW	4,905

Decomposing the Industrial sector into select end markets presents a distinct divide. The market favors those companies selling into energy- and power-related industries and is understandably cautious about those selling into construction markets. The weakness in housing-related and construction-centric groups is tied to the markets' on-going concerns that consumer credit and the housing market can only slow further.

Figure 4 depicts the performance of the energy-tied Industrials. In short, the market has continued to favor this sub-segment of the Industrial exposure. Unless one has a radically more constructive view on the Housing/Consumer Credit situation, this current leaning towards Industrials, and more importantly, Industrials with an energy/efficiency bent, this trade remains open.

Our 16 October *Active Voice* report on Industrials argues that industries such as Construction & Engineering and Construction Machinery are expensive.

Fig 4: Markets are likely to reward energy-related Industrials and penalize those firms related to Housing and Construction.



Source: Cirrus Research

Mid Cap Industrials: Quality Metrics

		Valuation				Quality Metrics			
		Fwd P/E	EV/EBITDA	Price/Book	ROE	Debt/Cap	Market Value	Earnings Dispersion ¹	
Aerospace & Defense									
GR	Goodrich Corp.	18.7	N/A	3.5	18.8	0.18	7,910	0.01	
LLL	L-3 Communications Holdings Inc.	17.5	10.2	2.1	11.9	0.27	12,060	0.02	
ATK	Alliant Techsystems Inc.	17.3	11.5	5.4	30.3	0.31	3,538	0.01	
Building Products									
ASD	American Standard Cos. Inc.	15.5	N/A	5.5	41.2	0.18	7,510	0.11	
AWI	Armstrong World Industries Inc.	15.2	6.5	1.1	65.2	0.23	2,381	0.00	
OC	Owens Corning Inc	21.0	7.0	0.9	213.0	0.39	3,265	0.17	
Const. & Engineering									
JEC	Jacobs Engineering Group Inc.	32.9	16.1	4.7	15.9	0.01	7,925	0.01	
FLR	Fluor Corp.	34.0	N/A	6.0	15.6	0.05	11,229	0.02	
FWLT	Foster Wheeler Ltd.	24.0	N/A	29.2	115.8	0.02	8,443	0.07	
Elec. Comp. & Equip.									
CBE	Cooper Industries Inc.	16.2	N/A	3.4	21.8	0.12	9,400	0.01	
AME	Ametek Inc.	21.0	12.6	3.9	19.2	0.14	4,281	0.00	
HUB.B	Hubbell Inc. (CI B)	16.4	10.6	3.1	16.4	0.06	3,213	0.02	
Multi-Industry									
CSL	Carlisle Cos.	16.3	10.4	2.9	16.3	0.10	3,060	0.00	
TFX	Teleflex Inc.	18.4	7.9	2.3	12.2	0.14	3,063	0.01	
LUK	Leucadia National Corp.	N/A	74.0	2.3	1.1	0.15	9,614	N/A	
Const. Machinery									
JOYG	Joy Global Inc.	18.2	9.8	7.0	41.8	0.09	4,688	0.01	
MTW	Manitowoc Co.	17.5	10.6	5.2	27.0	0.05	4,986	0.02	
TEX	Terex Corp.	15.3	N/A	3.9	23.8	0.07	8,140	0.02	
Farm Machinery									
AG	AGCO Corp.	28.4	11.1	2.4	-2.1	0.15	3,955	0.04	
Heavy Trucks									
CMI	Cummins Inc.	17.0	8.1	3.8	22.7	0.05	11,866	0.02	
OSK	Oshkosh Truck Corp.	16.5	12.1	3.3	18.1	0.42	4,294	0.01	
TRN	Trinity Industries Inc.	10.7	N/A	2.0	16.0	0.30	3,047	0.02	
Industrial Machinery									
DCI	Donaldson Co. Inc.	21.0	N/A	4.8	23.7	0.09	3,022	0.01	
HSC	Harsco Corp.	19.9	N/A	3.6	17.8	0.22	4,685	0.01	
PH	Parker Hannifin Corp.	14.9	N/A	2.6	17.6	0.09	12,484	0.03	
Industrial Dist.									
GWW	W.W. Grainger Inc.	18.6	9.5	3.3	17.2	0.00	7,731	0.01	
FAST	Fastenal Co.	28.8	17.7	7.0	21.7	0.00	6,868	0.01	
CPRT	Copart Inc.	21.1	9.4	2.9	15.0	0.00	2,592	0.01	

¹ Earnings Dispersion is defined as the Standard deviation of earnings estimates divided by the consensus mean estimate for FY1.

Source: Cirrus Research

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Cirrus Benchmarks

Asset Class	Market Cap Range
Nano Cap	\$10 mn - \$100 mn
Micro Cap	\$100 mn - \$600 mn
Small Cap	\$600 mn - \$2.4 bn
Mid Cap	\$2.4 bn - \$10 bn
Large Cap	>\$10 bn