The Turnaround Letter

Volume 27, Number 6 December 2012

YEAR-END BOUNCE CANDIDATES: LOSERS BECOME WINNERS (AT LEAST FOR A WHILE)

Most of the time, we advise taking a long-term view and focusing on stocks where the underlying business fundamentals are turning around. However, around this time of year it is worth considering a shorter-term strategy based more on the quirks of the calendar – and the tax law – than on business fundamentals.

Every year around this time we see certain stocks get pushed down by artificial selling pressure. That pressure is removed after year-end, often causing those stocks to pop up nicely. The artificial selling pressure comes from two sources: tax-loss selling and portfolio window dressing.

Late in the calendar many investors begin thinking about their tax bill. This causes them to sell losing stock positions to realize capital losses that can be used to offset other gains that they may have. Around the same time, many professional portfolio managers begin worrying about their year-end reports to clients. They would rather not have their losing stocks show up in those annual reports, and so they sell the offending positions to get them out of the portfolio before it is memorialized at the end of the year.

The new year brings a clean slate with respect to both tax and reporting issues. When the artificial selling pressure stops, many of the previous year's dogs jump up and suddenly become investor darlings – at least for a while. Ultimately, longer-term fundamentals will drive the prices of these stocks, but you can often make good money from this year-end bounce pattern.

For example, a year ago the ten year-end bounce candidates that we identified in the December issue significantly outperformed the S&P 500 through January. The outperformance narrowed, but was still meaningful, through the end of March. But by November the poor fundamental results from several companies on the list had dragged the group's performance below the S&P's. This is similar to the strong short-term performance (and weaker long-term performance) that we saw from the year-end bounce candidates that we identified in December 2010.

Given the good performance of our year-end bounce stocks for the last two years, this year we are following the same stock-picking formula. The bounce candidates below represent the worst performers in the S&P 500 over the first 11 months of 2012. ➔

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Will Calendar Provide Profitable Bounce?						
Company	**Symbol**	**Recent Price**	**52-Week Range**	**Market Cap. Mil.**	**Price to Sales**	**Debt to Equity**
Advanced Micro Devices	AMD	2.04	8.35 - 1.81	1,450	0.23	1.92
Allegheny Technologies	ATI	26.32	53.00 - 25.35	2,820	0.54	0.54
Apollo Group	APOL	19.58	58.29 - 18.36	2,200	0.51	0.78
Best Buy	BBY	12.95	28.53 - 11.41	4,370	0.09	0.49
Cliffs Natural Resources	CLF	28.89	78.85 - 28.33	4,120	0.68	0.54
Hewlett-Packard*	HPQ	12.89	30.00 - 11.35	25,320	0.21	1.25
J. C. Penney	JCP	18.14	43.18 - 15.69	3,980	0.28	0.85
Newfield Exploration	NFX	24.15	47.40 - 23.56	3,210	1.22	0.76
Pitney Bowes	PBI	11.09	19.65 - 10.79	2,230	0.45	8.74
R. R. Donnelly	RRD	9.39	15.22 - 8.72	1,690	0.17	3.29

**Previous TL Recommendation*

ADVANCED MICRO DEVICES is the second largest maker of chips used in personal computers behind Intel. When the market for PCs is strong, AMD thrives, and when PC sales are weak – as they are now – AMD struggles. The company has a fair amount of financial leverage, which magnifies the stock price moves in both directions. While AMD's long-term prospects are unclear, the stock has good potential for a short-term bounce.

ALLEGHENY TECHNOLOGIES is one of the largest and most diversified specialty metals producers in the world. As might be expected, the company's operating performance is heavily dependant on broad economic growth, particularly in China. We wouldn't dream of trying to make an economic forecast, but that doesn't dampen our enthusiasm for Allegheny as a year-end bounce candidate.

APOLLO GROUP was one of several for-profit universities that rode a wave of demand for its largely online educational services. But as politicians began to look into the industry's practices and competition from state schools began to rise, the operating models of many for-profit schools have not held up. Apollo is adapting to the new environment, and we suspect there is another chapter to be written for the company.

BEST BUY begins this Christmas shopping season under a cloud as investors fear that the old bricks-and-mortar retailer model cannot survive competition from the Internet. To revive its fortunes, Best Buy brought in a new CEO with turnaround credentials this past August. Buyout rumors have added to the stock's volatility. If the company can post decent holiday numbers, the stock could really pop in January. If a buyout came to pass, that would boost the stock even further.

CLIFFS NATURAL RESOURCES is a supplier of iron ore pellets used in steel manufacturing. The company accounts for just over one third of U.S. and Canadian pellet capacity. Here again, demand from China will have a major effect on longer-term results. Recent downgrades from some brokerage firms are likely to increase the year-end pressure on the stock.

HEWLETT-PACKARD is in the process of reinventing itself, but the bad news keeps on coming. Most recently the company announced an $8.8 billion write-off related to the 2011 acquisition of UK-based Autonomy. We suspect the selling that took the stock down to within a whisker of a nearly 18-year low will lead to a good bounce in early 2013.

J. C. Penney's results had been lackluster for some time before the board of directors brought in new CEO Ron Johnson in late 2011. Johnson, who was credited with visionary retailing initiatives at Apple, has made major changes at Penney. He has radically revised store layouts, products and pricing. So far, the changes have driven away more customers than they have attracted, and this has driven away many investors as well. If there are signs of bottoming over the holiday season, that could enhance the calendar-based rebound potential.

Newfield Exploration is an independent energy exploration/development company. A couple of years ago management decided to move out of the Gulf of Mexico and diversify away from natural-gas production. It has sold a number of non-core assets. The stock looked as though it was leveling off in late summer after a year-long slide, but then management gave a gloomy short-term outlook, which drove the shares down an additional 17% in one day. If natural gas prices continue their recent rebound, that would accelerate a possible jump.

Pitney Bowes, best known for its mail handling equipment, is struggling to find a niche in the digital age. Moreover, recent strategic acquisitions have leveraged the balance sheet. But decent cash flow suggests that the company isn't going away any time soon. The stock has been quite heavily shorted; a calendar-based bounce might force some short sellers to cover their positions, thereby pushing the stock up further.

R.R. Donnelly is the nation's largest printer of a wide range of products, including catalogs, inserts, magazines, books and financial documents. Clearly, traditional printing is not a growth sector in this increasingly digital world. Donnelly is making acquisitions to better align its product offerings with customer demand, and strong cash flow is buying management time to transition operations. At any rate, the company will certainly be around long enough to have the potential for a good year-end rebound in its stock.

DEFENSE STOCKS: CLIFF MAY NOT BE THAT STEEP?

As we approach the so-called "fiscal cliff," investors are clearly very nervous about defense stocks. Most of the stocks in this sector fell very sharply after the election, and while they have bounced back somewhat since mid-November, they still look pretty cheap to us.

Of course, these investor concerns are not completely unfounded. If Congress and the White House cannot come up with a compromise and we go over the "cliff," there would be mandatory cuts in federal defense spending. Our best guess – and we emphasize "guess" – is that Washington will find a way to avoid the cliff. But we also believe that most, if not all, of the risks from the cliff are already priced into defense stocks. Also, many of the defense stocks we highlight below pay healthy dividends, which should dampen any cliff-related volatility. Many of the companies have been stockpiling cash over the last couple of years, which they could use to further enhance their dividends or to repurchase stock.

AAR provides a variety of aircraft support services to both governmental and commercial customers. Growing commercial sales helped boost revenues above $2 billion in fiscal year 2012 ended in May. Recent results have ➔

Good Defense Can Be Good Portfolio Offense						
Company	**Symbol**	**Recent Price**	**5 Year Range**	**Market Cap Mil**	**Forward P/E Ratio**	**Dividend Yield**
AAR	AIR	15.29	39.42 - 9.69	589	7.8	2.0%
Alliant Techsystems	ATK	61.12	119.18 - 43.08	2,000	8.7	1.7
Curtiss-Wright	CW	31.66	56.07 - 22.62	1,480	10.6	1.2
Ducommun	DCO	14.95	38.84 - 7.71	158	8.6	NA
GenCorp	GY	9.10	12.31 - 1.80	551	26.0	NA
General Dynamics	GD	66.53	95.13 - 35.28	23,490	9.1	3.1
L-3 Commun. Holdings	LLL	77.45	115.29 - 57.12	7,280	9.8	2.6
Lockheed Martin	LMT	93.04	120.30 - 57.41	29,900	11.4	4.9
Raytheon	RTN	56.85	67.49 - 33.20	18,750	10.5	3.6
Rockwell Collins	COL	56.90	76.00 - 27.67	7,980	11.2	3.2

been pretty decent, and management reaffirmed a positive outlook.

ALLIANT TECHSYSTEMS is the largest supplier of ammunition to the Pentagon and is a significant provider to other markets, including the sporting/hunting markets and law enforcement. They are also the world's largest solid-fuel rocket engine manufacturer. The diversity of Alliant's businesses creates cross-currents; for example, a weakening defense market for munitions is being offset by surging demand from private sector gun enthusiasts. The net of it all is that Alliant has generally reported strong operating results and recently raised its guidance.

CURTISS-WRIGHT traces its history to the beginnings of flight (the Wright brothers) and naval aviation (Glenn Curtiss). The company's core engineering expertise is in advanced technologies for harsh operating environments; about 40% of revenues are derived from defense-related programs. Operating results bounced back in 2010 and 2011, but the stock has gone basically nowhere since the financial meltdown in late 2008.

DUCOMMUN specializes in components for commercial and military aircraft, helicopters, missiles and space vehicles. The company appears well positioned in important technology-driven markets, such as commercial aircraft and the Black Hawk helicopter. Moreover, it is reporting expanding backlogs, and it consistently generates strong cash flow. Nonetheless, the stock has gone essentially sideways since late 1996, making it look quite attractively priced today.

GENCORP brought in a new CEO in 2010 who implemented a new operating model around space and launch systems, tactical systems, missile defense and strategic systems and advanced programs. Strong cash flow is being used to develop new products as well as pay down debt. Adding to the company's asset value is 12,200 acres of land near Sacramento California that it bought in the 1950's as a testing facility. This land is now being developed for sale and could be very valuable. This gives GenCorp interesting potential.

GENERAL DYNAMICS had a pretty good run into the bull market high in 2008, but the stock has been lackluster ever since. The company's defense activities include sophisticated electronics for weapon systems, ground combat vehicles and shipbuilding. Its commercial aerospace unit, the driver of recent operating results, produces Gulfstream jets. The stock is at historically low valuation levels, and the balance sheet is strong.

L-3 COMMUNICATIONS HOLDINGS derives roughly 75% of revenues from the Department of Defense, mostly for intelligence and secure communications systems. Management is working to lessen the firm's dependency on the government, as demonstrated by the July spin off of a portion of its government-services business. The spin-off is expected to improve L-3's profit margins and growth prospects. The stock has been in a correction mode since early 2008, and, as a result, looks very reasonably priced. Strong free cash flow will be used for stock buybacks as well as perhaps increasing the already respectable dividend.

LOCKHEED MARTIN is the world's largest maker of military weapons. In 2011, roughly 82% of sales were to the U.S. government, with much of the balance going to defense departments in other countries. Management has been preparing for defense cutbacks for several years by cutting headcount and reducing its manufacturing footprint. The company has also built up a substantial hoard of cash – $4.6 billion. It is hard to bet against Lockheed given the stock's attractive valuation and generous dividend (which was recently increased).

RAYTHEON derives about three fourths of revenues from the U.S. government. However, international sales have been growing, particularly in Asia and the Middle East. An emphasis on managing costs has helped boost profitability. Recent contract awards will bolster an already substantial backlog. The balance sheet is very solid, and strong cash flow will help sustain a very attractive dividend.

ROCKWELL COLLINS is a global manufacturer of communications and aviation electronics for both the commercial and military applications. The company has faced its share of headwinds in recent years, but management has done a good job of responding to these events. Rockwell recently won a significant contract from Boeing. The company has also broken ranks with much of the industry by factoring the cliff into its guidance, and so there should be few surprises going forward.

RECOMMENDATIONS

Purchase Recommendation: United Continental Holdings

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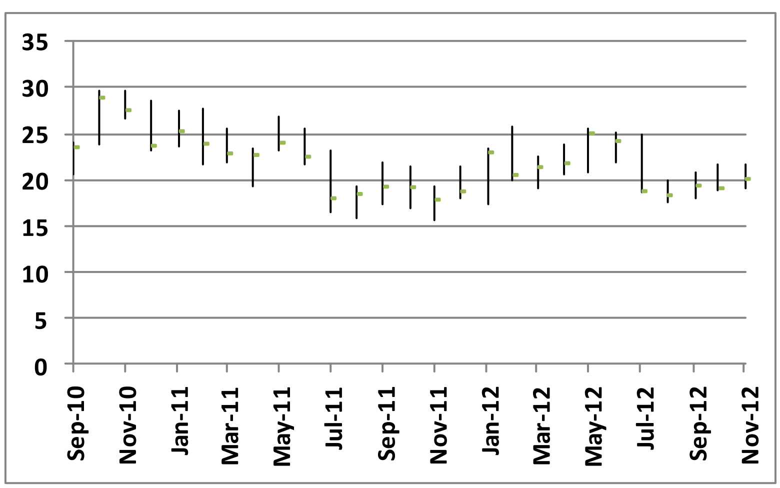
CATEGORY: MID-CAP ($6.59B)
SYMBOL: UAL EXCHANGE: NYSE
BUSINESS: AIRLINES
ANNUAL REVENUE: $37.1B (12/31/11)
EARNINGS: $840M
11/30/12 PRICE: 20.22
12 MONTH RANGE: 17.25-25.84
MAX. REC PRICE: 27
EST. DIVIDEND YIELD: 2.7%



Background: United Continental Holdings is one of the largest passenger airlines in the world. It was formed by the merger of UAL (parent of United Airlines) and Continental Airlines in October 2010. Like many airlines, both of the merger partners had previously been through bankruptcy. Continental had filed for Chapter 11 twice, in 1983 and again in 1990, and United filed in 2002.

The integration of the two airlines has proven more challenging than management expected. As a result, the stock is down more than 30% from the time of the merger, and it has lagged a number of the other airline stocks recently.

Analysis: The major airline stocks remain out of favor with most investors despite solid results for several quarters. Perhaps it relates to bad memories of past bankruptcies and stock volatility. We like the airlines in general because most of them have used bankruptcy effectively to reduce their cost structures and improve their balance sheets. (AMR, parent of American and the last major carrier to file for Chapter 11, is doing that right now.) Moreover, unlike past business cycles when the airlines expanded quickly and then were over-extended when the economy turned down, most airlines have been very disciplined in managing capacity in the last few years. In addition, industry consolidation has improved profitability, and this trend is likely to continue as AMR ponders its future. Among the airlines, we particularly like United Continental right now because of its strong international route structure and the poor recent performance of its stock, which we view as temporary.

The United Continental merger certainly has not gone smoothly. Most recently, computer problems forced the carrier to ground a number of flights for several hours on November 15. On top of the integration issues, the airline suffered considerable lost revenue from Hurricane Sandy because Newark and Washington, DC are two of its major hubs.

But these issues will eventually go away. We don't know exactly when the merger-related glitches will stop, but we suspect it will be pretty soon. Once this finally happens, passengers will come back to the airline, and the integration costs will go away. The impact of Sandy is already in the rear view mirror.

Longer-term, we believe United Continental is well positioned. The United side has long dominated the lucrative Asian routes, and Continental provides good coverage in areas of the U.S. where United was weaker. Once the integration problems are solved, the combined airline should be able to generate significant efficiencies and cost-savings.

Because of investor wariness about the industry in general and short-term concerns about United Continental in particular, the stock is trading at quite a low valuation – about ten times this year's expected earnings and perhaps as low as five times next year's. As the airlines in general begin to show more consistent results, investors will give the group higher multiples, and as UAL's integration issues recede, its stock should rise even further.

<u>We recommend buying United Continental stock up to 27.</u>

<u>Disclosure Note:</u> Accounts managed by an affiliate of the Publisher own UAL stock.

NEWS NOTES & UPDATES

Two of our recommended companies have announced special dividends. **Drew Industries** will pay $2.00 per share on 12/20 to holders of record on 12/10. **Carnival** announced a special dividend of $0.50 with a pay date of 12/28 and a record date of 12/7.

Marsh & McLennan moved above our maximum buying price of 35. We believe that the turnaround is continuing, and we are raising our buying ceiling to 40.

PERFORMANCE

The tables below and on the next page show the performance of all of our currently active recommendations, plus recently closed out recommendations. The categories are based on market capitalization on the recommendation date, except that recommendations made prior to August 2004 are categorized by their 8/20/04 market cap.

SMALL CAP (under $1 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	11/30/12 PRICE	TOTAL RETURN (3)	CURRENT STATUS (2)
Bristow Group	BRS/N	Nov 86	0.75	52.10	+6980	Hold
Kadant Inc	KAI/A	Apr 02	14.28	24.25	+70	Hold
Newpark Resources	NR/N	June 06	5.65	7.80	+38	Buy (10)
Electro Scientific Ind.	ESIO/O	Feb 07	21.24	10.84	-48	Buy (20)
CTS Corporation	CTS/N	Nov 07	12.54	8.86	-25	Buy (15)
Wet Seal	WTSLA/O	Oct 09	3.93	2.93	-25	Buy (6)
ACCO Brands	ACCO/N	Mar 10	7.17	6.74	-6	Buy (12)
Superior Industries	SUP/N	Sept 10	14.75	18.94	+36	Buy (30)
Kemet	KEM/N	Feb 11	14.75	4.42	-70	Buy (11)
Drew Industries	DW/N	Mar 11	23.13	32.46	+40	Buy (33)
Fairpoint	FRP/O	July 11	9.42	7.49	-20	Buy (14)
OfficeMax, Inc.	OMX/N	Nov 11	5.12	10.00	+96	Buy (12)
Builders FirstSource, Inc.	BLDR/O	May 12	4.17	5.20	+25	Buy (7)
Exide Technologies	XIDE/O	July 12	3.36	2.89	-14	Buy (5)
Felcor Lodging Trust, Inc.	FCH/N	Nov 12	4.39	4.20	-4	Buy (7)

MID CAP ($1 billion - $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	11/30/12 PRICE	TOTAL RETURN (3)	CURRENT STATUS (2)
Newell Rubbermaid	NWL/N	June 04	23.24	21.81	+15	Buy (25)
Goodyear Tire	GT/N	July 04	9.14	12.60	+38	Buy (20)
Tenet Healthcare	THC/N	Sept 04	41.08	28.96	-30	Hold
Janus Capital Group	JNS/N	Aug 05	15.27	8.20	-40	Buy (17)
Portland General	POR/N	Nov 06	25.70	27.03	+28	Buy (33)
Interpublic Group	IPG/N	Dec 06	11.94	10.82	-5	Buy (14)
Tellabs	TLAB/O	Feb 08	6.66	3.56	-43	Buy (7)
Federal-Mogul	FDML/O	May 08	21.00	7.86	-63	Buy (15)
Old Republic	ORI/N	June 08	14.64	10.49	-7	Buy (14)
Terex Corporation	TEX/N	Feb 09	12.57	24.19	+92	Hold
Calpine	CPN/N	Dec 09	11.12	17.26	+55	Buy (21)
Lear	LEA/N	June 10	33.84	43.67	+32	Buy (58)
Boston Scientific	BSX/N	Aug 10	5.60	5.54	-1	Buy (9)
Owens Corning	OC/N	Dec 10	26.31	34.58	+31	Buy (40)
MGIC	MTG/N	Jan 11	10.11	1.75	-83	Buy (8)
Delta Air Lines	DAL/N	Oct 11	8.11	10.00	+23	Buy (12)
MetroPCS	PCS/N	Dec 11	8.38	10.65	+27	Hold
Wendy’s	WEN/O	Mar 12	5.18	4.66	-9	Buy (8)
E*Trade Financial	ETFC/O	Aug 12	7.53	8.42	+12	Buy (12)
Veolia Environnement S.A.	VE/N	Oct-12	10.82	10.82	0	Buy (16)

KEY: (1) Exchanges: N = New York; A = American; O = OTC; (2) Maximum recommended buy prices in parentheses; (3) Total return includes dividends

LARGE CAP (over $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	11/30/12 PRICE	TOTAL RETURN (3)	CURRENT STATUS (2)
Carnival Corporation	CCL/N	Jan 01	30.50	38.66	+56	Buy (45)
A T & T Inc.	T/N	May 03	23.05	34.13	+109	Buy (44)
Ford	F/N	Dec 03	13.00	11.45	-3	Buy (15)
Schwab	SCHW/N	Mar 04	12.20	13.10	+29	Buy (20)
Time Warner	TWX/N	Dec 04	53.46	47.30	+12	Buy (55)
Campbell Soup	CPB/N	Apr 05	28.14	36.75	+56	Buy (42)
Microsoft	MSFT/O	Oct 06	27.94	26.62	+8	Buy (40)
Pfizer	PFE/N	Mar 07	25.84	25.02	+17	Buy (30)
General Electric	GE/N	July 07	38.12	21.13	-34	Buy (25)
Motorola Solutions	MSI/N	Aug 07	68.52	54.45	-18	Buy (60)
Amgen	AMGN/O	Oct 07	56.56	88.80	+59	Buy (95)
DuPont	DD/N	Jan 08	45.07	43.14	+12	Buy (60)
Sprint	S/N	Mar 08	8.09	5.73	-29	Hold
Bank of America	BAC/N	Oct 08	35.00	9.86	-71	Buy (14)
Emerson Electric	EMR/N	Aug 09	36.03	50.23	+55	Buy (65)
Sysco	SYY/N	Nov 09	27.01	31.65	+29	Buy (36)
Marsh & McLennan	MMC/N	Feb 10	21.71	35.22	+73	Buy (40)
Applied Materials	AMAT/O	Apr 10	13.45	10.73	-13	Buy (20)
Fifth Third	FITB/O	Nov 10	12.56	14.64	+20	Buy (17)
Coca-Cola	KO/N	Apr 11	32.86	37.92	+24	Buy (45)
General Motors	GM/N	May 11	32.09	25.88	-19	Buy (40)
Xerox	XRX/N	Aug 11	9.58	6.81	-28	Buy (14)
Sony	SNE/N	Sept 11	22.01	9.74	-56	Buy (32)
Johnson & Johnson	JNJ/N	Jan 12	65.45	69.73	+9	Buy (85)
Corning, Inc.	GLW/N	Feb 12	12.61	12.23	-2	Buy (18)
Weyerhaeuser Co.	WY/N	Apr 12	21.89	27.56	+27	Buy (30)
Hewlett-Packard	HPQ/N	Jun 12	22.74	12.99	-42	Buy (30)
Cisco Systems, Inc.	CSCO/N	Sept 12	19.18	18.91	-1	Buy (26)

RECENTLY CLOSED OUT RECOMMENDATIONS (ALL CATEGORIES)

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. CAT.	BUY ISSUE	PRICE AT BUY	SELL ISSUE	PRICE AT SELL	TOTAL % RE-TURN (3)
Tyco International LTD	TYC/N	Mid	Mar 09	20.05	Mar 12	52.00	+172
Taiwan Semiconductor	TSM/N	Large	Dec 05	9.29	Mar 12	14.69	+88
Winn-Dixie	WINN/O	Small	Jan 10	10.14	Mar 12	9.50	-6
Presstek	PRST/O	Small	June 05	8.58	Apr 12	0.58	-93
Midas	MDS/N	Small	July 08	13.50	May 12	11.50	-15
U.S. Airways	LCC/N	Small	May 09	3.79	June 12	12.69	+235
Sara Lee	SLE/N	Large	Apr 06	15.28	July 12	20.28	+57
Bristol-Myers Squibb	BMY/N	Large	Aug 03	26.07	Aug 12	35.63	+78
ExxonMobil	XOM/N	Large	Oct 10	61.79	Sept 12	87.90	+49
M/I Homes, Inc.	MHO/N	Small	July 10	10.08	Oct 12	19.34	+92
Kraft	KRFT/O	Large	Aug 08	30.24	Nov. 12	45.56	+51
Mondelez	MDLZ/N	Large	Aug 08	19.32	Nov. 12	26.55	+37

The Turnaround Letter is published monthly by **New Generation Research, Inc.**, 1212 Hancock Street, Suite LL-15, Quincy, MA 02169.

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