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Capital Goods Are a Capital Idea

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Capital Goods

- The Peter Lynch strategy likes Eaton's 0.40 PEG ratio.
- Fuel Tech's price within 10% of its 52-week high is favored by the William O'Neil strategy.
- Warren Buffett's strategy smiles upon Graco's dominant market position.

The capital goods sector today lacks strong direction. It shows neither great strength nor considerable weakness.

For example, the U.S. Commerce Department in late December reported that new orders for capital goods excluding aircraft and defense, an indicator of business investment in the months ahead, declined 1.4% in November from October, after a 3.9% drop the previous month. But a number of observers say that businesses will be making decent-sized investments this year, and that would be good for capital goods makers.

I mention this because when things in a sector are not clearly going in any one direction, it could be time for investors to jump in. Stocks in the sector are unlikely to be overpriced, yet the prospects for the sector's companies can be at the point where they will experience a strong uptick when things start heading up.

For this reason, I just ran a screen of assorted capital goods companies to see if the guru strategies I use to pick stocks find any of them worthy of your investment. In fact, several get a high grade from one strategy or another. Take a look at these companies. They are not in exciting industries, but they could turn into exciting stocks if the economy begins to heat up as it did in early 2006, when it grew at over 5%.

Eaton

Eaton (ETN) , a manufacturer of hydraulic systems, electrical power control devices and components for automobiles and trucks, is a favorite of the strategy I base on Peter Lynch's writings.

The company comes under the category of "fast grower" because its earnings per share, on the basis of the average of its three-, four- and five-year historical EPS growth rates, is a very high 32.88%. When this growth rate is combined with the stock's P/E ratio of 12.99, the Lynch strategy's famous PEG ratio (growth relative to P/E) comes in at a very favorable 0.40. The lower the PEG the better, and a PEG below 0.5 is quite impressive.

The inventory-to-sales ratio has not changed appreciably in the past year, which is another positive sign, while the company's total debt-to-equity ratio of about 1:2 is not great but acceptable. What we have is a company whose earnings are rapidly growing while its stock is modestly priced. That's a nice combination.

Fuel Tech

Fuel Tech (FTEK) , which develops clean-energy engineering solutions, such as emission controls used by utilities and industrial companies, gets a nod from the strategy I base on my understanding of William O'Neil's approach to investing.

Some things the O'Neil strategy likes about Fuel Tech: High annual earnings growth (73.13%) over the past five years, earnings consistency (four of the past five years have seen an increase in EPS), a stock price within 10% of its 52-week high (this is desirable because it could signal that the stock is about to break out to new highs) and a very strong relative strength of 96 (relative strength measures a stock's performance relative to the overall market).

Further, there are 38 other companies in that sector with a relative strength above 80, which is confirmation of Fuel Tech's attractiveness. In addition, the growth of the last fiscal quarter's EPS compared with that of the same quarter a year ago beat estimates by more than 25%, which is extremely upbeat to this methodology.

This company's stock is high priced, but the company's performance suggests to the O'Neil strategy that Fuel Tech could be headed to new -- and higher -- ground.

Watsco

The Lynch strategy likes **Watsco** (WSO) , a distributor of air conditioning, heating and refrigeration equipment, because its PEG ratio is a very desirable 0.5 (remember, 0.5 or less is "best case" with PEG ratios). EPS is also growing at the nice clip of 30.5%, based on the average of the three-, four- and five-year historical EPS growth rate. In addition, inventory relative to sales has fallen during the past year, while debt is quite a modest 12.78% of equity. All of these add up to a reasonably priced stock and a robustly growing company.

Graco

Graco (GGG) is a maker of systems and equipment that mix, dispense and spray fluids. In its niche markets, such as paint sprayers, it tends to be the dominant player, and that is part of the reason that Warren Buffett's strategy, as I understand it, likes this company.

The strategy looks for companies with strong market positions. Also in its favor is an earnings-per-share history that is very sturdy and predictable -- EPS has increased each year for the last 10. Another big plus is Graco's lack of any long-term debt.

Also during the past 10 years, Graco has enjoyed a return on equity of 35.4% and a return on total capital of 39.1%. These are terrific numbers. As for management, also over the past 10 years it has earned shareholders a solid 22.3% rate of return on earnings kept in the company. Management knows how to invest profits.

All of this is impressive, but the strategy also wants to be sure the stock is priced favorably enough that it will likely produce a desirable rate of return for investors. Using two different calculations, and then averaging them, investors can expect an annual return of 16.5%. This is impressive, and the Buffett strategy is very happy with it.

All of these capital goods companies are also likely to make investors happy. Nozzles for spray painters, air-conditioning equipment, emission controls and hydraulic systems -- they may not seem as exciting as, say, search engines, but they can produce some heady returns.

At the time of publication, Reese was long Fuel Tech and Graco, although holdings can change at any time.

John P. Reese is founder and CEO of Validea.com, an investment research firm, and Validea Capital Management, an asset management firm serving affluent investors and companies. He is also co-author of the best-selling book, The Market Gurus: Stock Investing Strategies You Can Use From Wall Street's Best. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Reese appreciates your feedback. Click here to send him an email.