When asked how the markets are doing, what’s the most common—yet the worst—answer? It’s that the S&P 500 or Dow Jones Industrial Average is down or up by a few points, right? But what does that really tell us about how the market is doing?

The problem is that for the top indexes, the way they’re run has little bearing on what’s actually happening in the market. The trouble starts with how the indexes are constructed and which stocks compose those indexes. Let’s investigate the most followed and tracked index: the S&P 500.

The widely followed index is market-weighted, meaning the stocks with the biggest market capitalization form the largest chunk of the index. The top 10 stocks control almost a quarter of the index’s movement.

This means only a handful of stocks dictate the movement of the index, virtually guaranteeing that the other hundreds of stocks inside the index remain overshadowed. At Personal Finance, we go beyond the handful of heavyweights in the S&P 500 and look for companies that can actually benefit from market trends. In recent years, that’s often meant looking at smaller capitalization stocks.

But even small-cap indexes can have the same problems as the big-cap indexes in that a small number of popular companies dictate their direction. However, if you go off the beaten path, you’ll discover an abundance of stocks that are cheap based on their fundamentals yet high on growth prospects. In this report we profile five of these opportunities, all growing quickly and trading at reasonable valuations.

We expect these companies to stay on top for some time to come, but be sure to check the website at www.pfnewsletter.com regularly for the most recent developments.

**Air Transport Services Group**

Air Transport Services Group (NSDQ: ATSG) is a lessor and operator of cargo planes. The company recently signed a contract with Amazon to shuttle a portion of its packages across the U.S. In a move to cement Air Transport’s position as a preferred air partner, Amazon was granted warrants to purchase up to 19.9% of Air Transport stock over five years.

While the 20 planes currently under the agreement will ignite earnings in 2017, it is likely that Amazon will expand the deal to control and dominate the next-day shipping its customers now expect.

Earnings were relatively flat last year while the company built out its capacity to handle the demand from Amazon. As the planes are deployed, earnings will skyrocket 40%.

Air Transport has been in the airfreight business since merging with ABX Air in 2007. CEO Joe Hete, who started with ABX Air in 1980, has over 35 years of experience in the industry.

Air Transport serves a particular niche in the logistics market with an innovative product. Large delivery companies like DHL lease planes to help supplement their own internal capacity or to outsource the function entirely.

Air Transport has been an excellent partner to DHL, which recently extended the terms of its leasing agreement to 2019. The extension of DHL’s contract, which made up almost half of Air Transport’s revenue in recent years, provides a stable base of profits from which the company will launch.

**Universal Forest Products**

Universal Forest Products (NSDQ: UFPI) is at a tipping point. This maker of wood and wood-alternative materials (everything from decking to
pre-fab homes) has been harvesting growth from acquisitions and new products. Thanks to more profitable products and a tight rein on expenses, Universal’s free cash flow (cash left over after paying for projects) is growing faster than ever.

CEO Matthew Missad has been stockpiling profitable businesses. Universal acquired seven companies in two years. After each acquisition, Universal improves the acquired products and cuts their costs. These adopted product lines often need money for better factories as well as for marketing and building inventory, all of which drain cash. But once the investments are made, the cash flow falls to the bottom line.

Universal purchased idX Corp. in September 2016 for $94.5 million to capitalize on idX’s expertise in specialized merchandising. The acquisition will allow Universal to increase its product mix and access new customers and markets.

New products, like Universal’s Deckorators Vault non-wood-composite decking, buoyed sales and more importantly gross margins, the profit per unit after subtracting costs. This decking product, which retailers began selling in January 2016, uses the company’s proprietary technology to produce one of the strongest and lightest decking materials on the market.

Universal makes efficient use of its growing pile of free cash to increase profits in various ways. The company used cash from operations to cover daily business costs like buying inventory but took advantage of low interest rates by financing acquisitions primarily with debt. That created a massive cash cushion that can be used to pay down debt or make additional acquisitions.

Universal benefits from an upturn not only in residential construction but also in multifamily construction and home-improvement projects. Most of its sales are domestic, with more than a third to retailers and the balance split between construction and industrial customers. Universal’s largest customer, Home Depot, generates about 17% of total sales and itself has seen consistent sales growth thanks to consumers’ insatiable demand for remodeling supplies. Multifamily construction, which industry source Freddie Mac expects will continue growing at a nice clip, will feed demand for Universal’s concrete-forming products.

It’s not easy to find a direct comparison for Universal’s stock. It has little in common with so-called competitors Deltic Timber or Louisiana Pacific. These companies grow and harvest trees for lumber, but their profits dwindled in recent years as lumber prices fell. Trex Corp. seems the best comparison. Less diversified than Universal, Trex makes only decking products but has delivered consistent profits selling to many of the same customers. Universal, which has more diversified earnings, deserves at least the same valuation given its lower risk.

Few analysts cover Universal’s stock, and management doesn’t offer detailed earnings forecasts. But based on the 49% average annualized earnings growth the company delivered over the past three years and considering its recent acceleration in profits, earnings should grow in the double-digits.

Helen of Troy

We were curious about what could heat up investors’ already steamy love affair with Helen of Troy (NSDQ: HELE), and digging through the company’s transcripts unearthed the reason. Helen of Troy’s beauty division, representing 30% of sales, had been in decline for three and a half years. Julien Mininberg, who became CEO in March 2014, hatched a plan to resuscitate beauty sales that paid off in second quarter 2015, when they grew 10%, the first increase in seven quarters. Since then, the company’s quarterly sales have been consistently higher than the same quarter in the previous year.

Helen of Troy’s beauty products are a mix of toiletries, styling tools and hair accessories. Although these products aren’t revolutionary, small bumps in demand add up to big jumps in revenue because of the massive number of retailers placing orders.

Other divisions grew even more, driven primarily by acquisitions. But incremental revenue from existing product lines (called organic growth), like the beauty category’s, is often valued more than acquired revenue because it proves a company can generate its own growth.
Helen of Troy has always augmented its growth by buying new brands. Companies like Jarden and Spectrum Brands follow similar strategies, scooping up unwanted brands that goliaths like Proctor and Gamble cast off to focus on mega brands.

Helen of Troy’s biggest acquisitions were OXO housewares in 2004 and Kaz in 2010. In June 2014 Helen of Troy added an entirely new product line by buying Healthy Directions, a manufacturer and retailer of nutritional supplements and vitamins. Helen of Troy now has four product divisions: beauty, housewares, healthcare/home environment, and dietary supplements.

OXO, known for the ergonomic handles and sleek design of its can openers and salad tongs, contributed steadily to growth. OXO ventured into the new category of small electric kitchen appliances with its digital toaster, filtered water coffee brewer and an immersion blender in September. The initial shipment to customers like Kohl’s, Bed Bath & Beyond and Williams-Sonoma will boost sales.

Helen of Troy funded most of these acquisitions with debt that is paid down slowly from the business’s cash flow. The business requires little investment in equipment, leaving most of that money available for debt reduction, new acquisitions, or stock repurchases. Earnings should grow 15% over the next five years. The company’s strategy of driving new brands while improving upon its current portfolio shows the brains behind this beauty.

**Movado**

Luxury brands get special treatment by the stock market. Tiffany’s, Under Armour and Ralph Lauren enjoy price-to-earnings (P/E) multiples much higher than their growth rates. But opportunities can be found when these high-fliers stumble, and alarm bells are ringing to buy Movado (NYSE: MOV), the designer of sophisticated, luxury watches.

The news that customers were accepting price increases on some of Movado’s watches sent the stock racing. As these higher prices don’t accompany higher costs, Movado’s profitability should improve. For 12 out of 14 recent quarters, Movado’s gross margin, the ratio that measures profit per watch sold, declined. Higher costs and a shift to lower-priced watches seemed to put a hex on this ratio.

High-end brands had a rough time last year. Overzealous expansion and buyer exhaustion hit Movado’s competitor, Fossil, hard. Fossil’s stock price was down nearly 60% in 2016 and shows no signs of life despite its “cheap” share price. But buying a cheap stock can get you stuck in the notorious value trap.

Case in point, back in 2015 Fossil shares looked cheap. The stock had plummeted 75% by the end of the year. Yet, months later, it’s down another 60% and trades at a P/E of 10 times 2016 estimates.

Most investors can’t stomach such gut-wrenching drops. Before news of its well-received price hikes, Movado shares experienced a drop of around 25%. It’s a less risky buy now that a turnaround is evident. Buying a stock only after a fundamental change takes root should help investors avoid waiting for profits.

Movado is introducing several new watch collections that have good customer reviews. Its Museum Dial watch, which was added to the Museum of Modern Art’s permanent collection in 1960, established the company’s stellar reputation for cutting-edge design. The watch’s clock face has no numbers, just one gold dot that signifies the sun at high noon.

A recent collaboration with designer Yves Behar builds on the Museum Dial design with futuristic metallic ridges in the concave dial. The new line, named Movado Edge, is expected to expand the Museum Dial watch’s popularity.

Recent launches of branded watches by Coach and Hugo Boss boosted sales. Although a weak euro depressed sales, growth adjusted for currency fluctuations increased the past two quarters.

At Movado, price increases are reserved for more expensive watches with less price sensitivity. Movado’s Sapphire men’s watch, which sells for roughly $1,000, was a best seller at Father’s Day. Lower price points, which management euphemistically calls “gateway” prices, are less receptive to increases and will be left untouched.

Besides better pricing and robust demand for new collections, Movado also spent the past year
whittling down costs so that any improvement in revenue should be magnified in earnings.

**Inteliquent**

We’d like to recommend buying shares of telecommunications firm Inteliquent, but we can’t. That’s because as of this writing, the company was in the process of being acquired by private equity firm GTCR for $23 per share.

We recently recommended shares in the mid-teens, which meant a gain of more than 40% for many of our subscribers. We’re sorry you didn’t get a chance to take part, but promise to provide equally profitable opportunities on a regular basis inside each issue of *Personal Finance*. 

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