



## OVERSEER'S UNDERCURRENT: Utilities' Perverse Relationship to Bullish Market

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With the Dow Jones Industrial Average surging toward its record high point, you might be wondering why in the world electric utility stocks seem moribund.

Even a quick glance at the daily financial pages shows that various stock indices are following a skyward momentum, with daily ups and downs tracking well above their 90-day rolling averages.

The lone exception appears to be the utility sector. Utilities are essentially flat-lining. Of the 15 U.S. utilities that constitute the Dow's utility index, only two or three have shown any positive gains during this month of upward thrust.

It's been no small feat for Pacific Gas & Electric and Edison International to rebound to the \$40 per share level they are seeing. Sempra sits happily above \$45/ share. In the five years since their brush with insolvency following the Western energy crisis, California's investor-owned utilities have come a long way.

Still, even as the rest of the market appears to be zooming to new highs, these stocks merely bounce around within their 52-week ranges (though PG&E just needs another \$1/share increase to top the past year's range). Even those national darlings TXU and Exelon no longer muster the momentum they showed during their boom days in 2004-05.

In a midweek snapshot of the ten sectors within the Dow's Wilshire U.S. industries index, utilities came in dead last, while telecommunications, basic materials, and consumer goods all showed strong gains.

I see the same complaints on various chat boards devoted to these stocks again and again: "When is this turkey going to take off?"

The answer is: Probably no time soon.

By their very nature, utility equities act more like bonds in the face of a bull stock market. As interest rates climb higher, and investors jump all over "growth" stocks, utilities and bonds seem to slip into a bearish hibernation.

The highest flyers on Wall Street trade at a share-price-to-earnings ratio approaching infinity, while the average these days generally exceeds 20:1. Utilities, in contrast, show the second-lowest price-to-earnings (P/E) ratios. They are temporarily ahead of the financial institutions and have the lowest share price to book value of all sectors. California utilities' P/Es are about 12, although PG&E's P/E is up to 17.3

this week.

Nationwide, utilities also offer the lowest return-on-equity (ROE) percentages in the field, with the average ROE for electric utilities being 12.3 percent. That's high compared to California's group. As a result of the most recent regulatory order on utility costs of capital, PG&E has a target ROE of 11.3 percent for 2006, Edison 11.6 percent, and Sempra 10.7 percent.

The regulated nature of utilities (their nonregulated market affiliates notwithstanding) means there is a trade-off between upside potential and downward spirals. Although market restructuring policies had envisioned loosening the utility corporations from their earthly bounds, it also removed the protective floor. In the post-Enron market depression, far too many utility and merchant energy stocks crashed rather than taking off for the skies.

Does that mean that utility stocks are losers? Uncompetitive in an up market?

Not entirely. They offer something else that most other equities have done away with in recent years - dividends. In fact, the dividend yield for utilities is the highest of any sector, about 3.65 percent.

That's money in the pockets of utility investors, with checks issued regularly, and a feature that few other sectors can boast. For those who participate, dividend reinvestment programs (Drips) are among the safest and surest ways to increase the value of one's portfolio.

But that's not enough for those with a greater risk tolerance and those who demand that energy stocks rival high technology and health care as growth industries.

Traditional utility indices just don't reflect the current reality.

"Join the Alternative Energy Revolution," proclaims a corner ad in my Wall Street Journal. A separate news item touts a new "Clean Energy" stock-performance index, joining a handful of other indices devoted to a seemingly new industry that matches new technologies with the demand for cleaner, more efficient energy production and distribution.

There are three such indices that have recently caught my attention:

? The Nasdaq Clean Edge U.S. Index, which will begin May 18, features 45 publicly traded companies that make products or technologies for solar, biofuels, or energy storage devices.

? The Merriman Next Generation Index, which began this week, similarly tracks stocks of about 30 small and mid-cap firms, with a mix of solar, fuel cell, and biofuels.

? The Distributed Energy Stock Index, a list of 30 companies ranging from "prime movers" to renewables and "enabling" technology firms, began almost a year ago.

While there is considerable overlap in the stocks these indices cover, they have in common that traditional utilities are nowhere to be found, and dividends are the last thing on the minds of their investors.

In the next few weeks, I expect to look more closely at these indices and the companies they include - not for their stock price growth

potential, but for how these firms may provide solutions to the challenges set by energy policies in California and the West for clean air, clean power, and a more productive energy system.

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