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Hard Lesson

Copying Peter Lynch, Investors Bought a Stock, Watched It Tank

Fund Star Reported a Stake In Tiny Firm, Which SEC Now Calls Fraud-Ridden

Big Guys Get Chance to Recoup

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Charles Glasgow has idolized Peter Lynch since the early 1990s, when he read his investment book "One Up on Wall Street." So when the 66-year-old former college professor heard of a stock Mr. Lynch had bought with his own money, he jumped at the chance to invest alongside him.

A regulatory filing in August 2003 showed that Mr. Lynch, the celebrated former skipper of Fidelity Magellan Fund, owned 1.8 million shares of tiny SafeScript Pharmacies Inc.


Peter Lynch

"He is the most brilliant investor ever," says Mr. Glasgow, of Denton, Texas. "I would not have touched this little company with a 10-foot pole except for his involvement." But "if it was good enough for Peter Lynch, it was good enough for me," Mr. Glasgow says, adding that he plowed nearly $498,000 into the stock and his relatives invested, too.

They were among hundreds of fans of Mr. Lynch following him into SafeScript stock. By late January this year, SafeScript had a stock-market value of $125 million. Mr. Lynch owned nearly 8%.

Then the roof fell in. In February, the company announced regulators were investigating its accounting. The chief executive and two other managers quit. Soon, the company filed for Chapter 11 bankruptcy protection. This month, the Securities and Exchange Commission revoked its stock registration and sued the company and four former officials, alleging it had inflated revenue and profit.

Mr. Lynch says he was baffled. "It was a total surprise, out of left field," he says. "It's a terrible tragedy."

Even the best investors have their misses, and Mr. Lynch freely admits this was one. "Just because I buy something doesn't mean it's going to work," he says. "People have to do their own homework." Mr. Lynch says he never sold any of his SafeScript stock, and took a beating along with others when it tanked.

But unlike those who mimicked his moves, he might still salvage something. After the trouble broke, a buyout group came forward and agreed to buy all of SafeScript for $3 million. According to people familiar with the situation, the buyers include Mr. Lynch. He declines to say one way or the other.

The case shows how badly things can go wrong as small investors try to ape the moves of celebrity stock-pickers. This copycat behavior is made easier by the Internet, because investors can quickly find out if an investment star has bought a 5% stake in a company and filed the required report to the SEC.

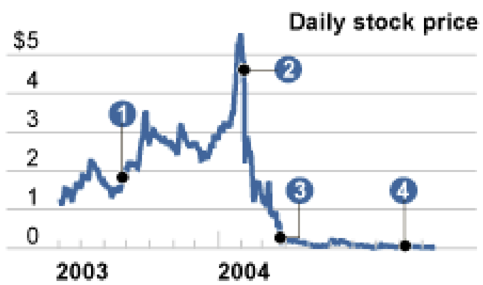
Big investors sometimes are getting stock more cheaply than the ordinary investor, by buying bonds convertible into stock or by doing deals with the target company such as purchasing shares directly from it.

Moreover, copycats frequently remain a step behind famous investors. In July 2002, Warren Buffett's **Berkshire Hathaway** Inc. bought convertible bonds of **Level 3 Communications** Inc. Investors jumped into Level 3's stock and drove it up 50%, to $4.36 a share. By February 2004, it was at $7.40. Only then did investors learn that Mr. Buffett had converted his bonds to Level 3 stock two months earlier -- and sold it. Level 3's share price is now down by half.

Mr. Buffett last year grew so tired of people following his moves that he tried to get special dispensation from having to disclose certain of his holdings. He complained to the SEC that copycats drove up prices and made it harder for him to build a position in a stock. The SEC denied his request.

ROUND TRIP

SafeScript Pharmacies' stock attracted Peter Lynch and Lynch fans, but left them poorer.



1. **Aug. 26, 2003:** Lynch reports 7.2% stake in company
2. **Feb. 3, 2004:** Company says SEC is investigating; CEO quits
3. **March 22:** Company files Chapter 11 bankruptcy
4. **Oct. 5:** SEC sues company, four officials, for fraud

Sources: Thomson Datastream; WSJ research

It's no surprise Mr. Lynch is someone investors would copy: When he ran the Magellan Fund from 1977 to 1990, it had a total return of 2,703%, versus 574% for the S&P 500. Mr. Lynch became a prominent figure, gracing magazine covers and serving as an admired public face of mutual funds as they grew more popular.

Mr. Lynch, 60 years old, says he vacations 100 days of the year, spending a lot of time at his farmhouse in Ireland. He remains vice chairman of Fidelity Management & Research Co., where he helps coach young analysts.

He is mum about his personal investments but says he has never sold a stock short -- bet on a decline -- and he doesn't handle outsiders' money. In a 2000 introduction to a new edition of "One Up on Wall Street," he said he owned about 50 stocks, many of them blue chips. But he also says he looks for "ten-baggers," small stocks with the potential to soar. He has said that even individuals can sometimes spot these if they keep their eyes open at work or at the mall for new products and trends.

SEC filings show Mr. Lynch owns 5% or more of several stocks: **WorldQuest Networks** Inc., Miller

Industries Inc., **VarsityBooks.com** Inc., **Abraxas Petroleum** Corp., Interep National Radio Sales, eRoomSystem Technologies Inc. and **Barbeques Galore** Ltd. Some trade on the National Association of Securities Dealers' OTC Bulletin Board.

Mr. Lynch lately has dabbled in complex deals and swapped ideas with other big investors, such as Andrew Barron Worden, who runs Barron Partners LP in New York. The two were part of a group that injected cash last year into Hartville Group Inc., a firm involved in health insurance for pets. Mr. Lynch says Mr. Worden last year mentioned SafeScript, then called RTIN Holdings. Mr. Worden declined to be interviewed.

The company began in the late 1990s as a restaurant chain, founded by Curtis Swanson and his father, Stanley, a former major-league outfielder (Montreal Expos, 1971). A couple of years ago they started buying pharmacies, and spotted an opportunity: electronically zapping doctors' prescriptions for potent pain medicine to a pharmacy. They bought software to do so and offered it to franchisees. The system, they told investors, would solve a problem in American medicine: Patients in chronic pain sometimes have trouble getting certain drugs because doctors and pharmacies fear liability if a prescription is misread.

Mr. Lynch invited Curtis Swanson, the CEO, to his Boston office last summer. Mr. Swanson is an impressive man who can dazzle people with his memory for numbers and details, says an investor-relations official for SafeScript, Yvonne Zappulla, who attended the meeting. Mr. Lynch says he enlisted a pharmacist and a health-care veteran to inspect the company. An analyst who works for him visited its pharmacies and headquarters, on the fourth floor of a building above a bank in the East Texas town of Longview.

The company "had all the right ingredients," Mr. Lynch says. He began buying shares on the open market. But he also got some at a discount. He and a New York firm called Pilot Capital privately sank $1.5 million into SafeScript. In return they got 600,000 units, each consisting of two shares of restricted stock and warrants to buy more shares at $1.50 each in three years.

Even if the warrants were worth nothing, the investors were getting shares at just $1.25 each. They had an even better deal if the warrants proved to have value. An individual buying SafeScript on the open market when Mr. Lynch's filing to the SEC became public had to pay $1.75 a share or more.

An SEC filing on Aug. 26, 2003, said Mr. Lynch owned 7.2% of SafeScript. The next day, the stock jumped 20% to $2.10 a share on the OTC Bulletin Board, as trading volume soared 800%.

A research firm called StockDiagnostics.com, which monitors firms' cash flow, urged the 2,400 subscribers to its newsletter to buy SafeScript. "Mr. Lynch is known world-wide for being a savvy investor and in name recognition he is as well known as Warren Buffet," it said.

At a prison in Enid, Okla., corrections officer Al Shaw read the newsletter during his break. He invested $15,000 in SafeScript, 18% of his savings. At the other end of the wealth spectrum, Dudley Willis, who manages money for the affluent Saltonstall family in Boston, also invested, because of Mr. Lynch. That "was the only reason I heard for us to invest," Mr. Willis says.

In December, StockDiagnostics.com's research director, Michael Markowski, noticed a problem with SafeScript's cash flow. He says he phoned Curtis Swanson at SafeScript and was told that Mr. Lynch was standing by and ready to invest more money.

The stock kept gaining. It reached $5.66 a share on Jan. 27 of this year.

A week later, an investor named Eddie Minton got a panicky call at his car-repair shop at a university in Wilmington, N.C. "Did you see the price of SafeScript?" asked his wife, Rosemary, a school secretary. Mr. Minton found a computer, logged on to his trading account and learned that the shares had plunged some 60%, ravaging a $28,000 investment he'd made with his wife and mother.

The company had just announced that the SEC "may commence an enforcement action against the company and certain executive officers" for securities violations. Curtis Swanson resigned.

As interim CEO, the company named Ed Dmytryk. After plowing through the books with an interim chief operating officer, he says he concluded that $2.5 million in cash was missing. The Justice Department began investigating, people familiar with the probe say.

John Hurley, the interim chief operating officer, says that according to the Swansons' accounting, SafeScript was on track to report $24 million in revenue for 2003. Actual revenue, he says, was $15.7 million. And while the books showed the company was virtually debt free -- a big factor for Mr. Lynch -- it had millions of dollars of undisclosed debt. Mr. Hurley says teary-eyed investors, many of them local people, stormed into the offices saying they were owed money.

For some, faith was a factor. Timothy Hayes, a Florida pharmacist, says he lent the company several hundred thousand dollars and worked free for a year as president of one of its units, partly because Stanley Swanson was a fellow born-again Christian. Mr. Hayes says that at executive meetings, the elder Mr. Swanson often led a prayer session, sometimes praying for cash and investors.

Company officials, debtors and lawyers said they couldn't find the Swansons, but the SEC said they were in Missoula, Mont. Attorneys for the two men declined to comment for this article.

On March 22, SafeScript filed for bankruptcy protection. To keep going, it got a $2.5 million loan from a small group that, according to people familiar with it, included Mr. Lynch. Called SS Acquisition LLC, it provided the cash as "debtor in possession" financing -- gaining priority over other creditors and a claim on company property as collateral. SafeScript was obligated to repay by Aug. 2.

To raise the money to do so, SafeScript sought a buyer for its assets. The only bidder was SS Acquisition. The group now is buying the whole company for $3 million, out of which its $2.5 million loan will be repaid.

Subscribers to the newsletter that recommended SafeScript have collectively lost $7.6 million, says Mr. Markowski, its now-former research chief. In letters and faxes, he urged Mr. Lynch to keep SafeScript public, so that existing shareholders might someday get some value for their shares. Mr. Lynch says the request should have been directed to the bankruptcy court. He declines to discuss whether he was involved in the buyout or talk about any plans the buyout group might have. Mr. Markowski today is launching a Web site called appealtopeterlynch.com[1] to give SafeScript investors information on what happened and urge them to lobby Mr. Lynch.

On Oct. 5, the SEC revoked SafeScript's stock registration as it filed suit against the company, the Swansons and two others. The suit says that when the SEC sought to question Stanley Swanson, 59, and Curtis, 35, both asserted their Fifth Amendment privilege against self-incrimination.

The suit, in federal court for the Eastern District of Texas, alleges a "fraudulent revenue recognition scheme" beginning in February 2002 -- more than a year before Mr. Lynch invested in SafeScript. It asserts that SafeScript sold franchises to buyers it knew didn't have the money to pay. When the company couldn't collect, it borrowed money from private investors such as Mr. Hayes, the suit says, forging documents and duping transfer agents to make it appear the money was coming from franchisees. Through this alleged scheme, SafeScript booked millions of dollars in fake revenues, inflating net income by as much as 998% in 2002 and 2003, the suit asserts.

Mr. Hayes, a prime SEC witness, says he threatened to sue SafeScript back in May 2003, but held off because Curtis Swanson told him "Peter Lynch was investing big money in the company."

Mr. Lynch says he was in the dark like almost everyone else. "Some of these work, some don't," he says.

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