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Company Overview

Headquartered in Indianapolis, Indiana, WellPoint, Inc was formed when WellPoint Health Networks Inc. and Anthem, Inc. merged in 2004 to become the nation's leading health benefits company. Through its nationwide networks and approximately 42,000 employees, the company delivers a number of leading health benefit solutions through a broad portfolio of integrated health care plans and related services, along with a wide range of specialty products such as life and disability insurance benefits, pharmacy benefit management, dental, vision, behavioral health benefit services, as well as long term care insurance and flexible spending accounts.¹

Serving over 34 million medical members, the company offers a broad spectrum of network-based managed care plans to he large and small employer, individual, Medicaid and senior markets. Its managed care plans include preferred provider organizations, health maintenance organizations, point-of-service plans, traditional indemnity plans, and other hybrid plans. In addition, the company provides a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management and other administrative services. Further, the company provides an array of specialty and other products and services including life and disability insurance benefits, pharmacy benefit management, and other health benefit services.²

Business Segments³

WellPoint manages its operations through three reportable business segments: HealthCare, Specialty, and Other. Exhibit 1 breaks the segments down by 2006 sales and earnings.

Exhibit 1

\$ Sales by line of business (% of total sales)		
Health Care:	\$53.8606 billion	96% of sales
Specialty:	\$3.5662 billion	6.3% of sales
Other:	\$(1.3522) billion**	(2.5)% of sales
\$ Earnings by line of business (% of total profit)		
Health Care:	\$4.2883 billion	90.5% of total profit
Specialty:	\$0.5236 billion	11% of total profit
Other:	\$(.075) billion**	(1.5)% of total profit
** due to elimination of intersegment revenue		

Health Care

The Health Care segment is an aggregation of various operating segments comprising a range of network-based health plans and other health care-related products to large and small employers and individuals. Wellpoint's Health Care operations include Anthem Blue Cross and Blue Shield plans.

Specialty

The Specialty segment provides various products, including pharmacy benefits management, dental, life insurance, disability insurance, behavioral health, and worker's compensation products and services.

Other

The Other segment includes results from the company's government health services and other businesses. Other businesses include subsidiaries such as UniCare, Adminastar Federal United Government Services and Empire Medicare Services. Unicare is Wellpoint's full-service health plan offered in different regions throughout the country where the company does not have a licensed BCBSA plan. Adminastar Federal United Government Services is one of the largest Medicare contractors in the United States.

Competitive Advantages⁴

Market Leadership

WellPoint's principal competitive advantage is its scale as the largest health care company by number of customers in the US. With close to 34 million medical members, it outrivals its closest competitor UnitedHealth, which has 27 million members. Its many members are spread throughout the country. It is one of the few companies with a national reach spanning 14 states in the US. Its number one market share in 13 of the 14 states in which the company operates increases its bargaining leverage with health care providers and its scale of operations allows it to offer health care at low cost.

Brand Image

WellPoint's exclusive right to market products under the most recognized brand in the industry, Blue Cross Blue Shield (BCBS), in its most significant markets provides it with an advantage over its competition. To say the least, the BCBS partnership makes WellPoint a unique and powerful insurer. Its relationship with BCBS gives it national reach with the 'Blue Card' arrangement and the well-regarded BCBS brand name. The relationship with providers in the BCBS network along with the customer service reputation of the BCBS allows Wellpoint to extract discounts and favorable pricing over competitors in almost any market.

Diverse Product Offering

WellPoint offers a robust suite of products including dental, vision, behavioral, pharmacy benefit management (PBM), disease management, administrative services contracts, Medicare and other analytical and medical management support services. WellPoint's large array of services and its ability to customize services to individual needs makes it appealing to customers for the ease of use and cost savings it represents. Thus, its large product portfolio makes it a preferred managed care company by individuals and large organizations.

Macroeconomic Factors

The macroeconomic factors that would affect WellPoint are not like those of companies in different industries. Not surprisingly, the demographics in the US are the most influential to WellPoint. According to the US Census Bureau, there are approximately 36.9 million Americans aged 65 or older in the US who comprise approximately 13% of the total US population in 2005. By the year 2030 the number of elderly people is expected to climb to 71.5 million, or 20% of the total population. Due to the increasing life expectancy of Americans, the number of people aged 85 years and older is also expected to increase from 4.3 million to 9.6 million by the year 2030.⁵ This increase in life expectancy will increase demand for healthcare services and more importantly, the demand for more innovative and sophisticated means of delivering those services. With 77 million baby boomers rapidly approaching an age when many will require long term care services, health care providers such as WellPoint would be able to provide them with quality care. In addition, nearly half of all Americans are expected to need long term care at some point in their lives. WellPoint as a leading commercial health benefits company is well positioned to gain from this increasing demand for healthcare services.⁶

Government regulations and legislation also plays a role in the success of WellPoint. New laws and policies put into action attempt to provide more affordable health care to a wider set of people. This can have an adverse effect on a company such as WellPoint because it now has to offer its products at a lower price and thus experience lower revenues and earnings. An example of this is the new Medicare Part D Prescription Drug Program for senior citizens. Profit margins for this government sponsored program are expected to be in the 4-6% range for most insurers. This is significantly below the 6-12% profit margins for more traditional health care products. This would put downwards pressures on the margins which are already low. Medicare Part D would also cannibalize drug coverage provided by dual eligible Medicare/Medicaid

recipients, Medicare Gap insurance products and other products like drug discount cards as it would replace them in few instances. This could adversely affect WellPoint's margins.⁷

Industry Analysis⁸

The health care sector of the S&P 500 can be considered to be defensive. Sales and earnings remain relatively stable during economic upturns and downturns due to the relatively inelastic demand for health care. That is not to say that the health care sector is free of change. Recent years have caused the sector to grow and adapt. As market share and cash flow have become the primary goals of the competing companies, the sector has become more mature. There are still areas however where growth is being experienced.

Improving life expectancy and rising income levels have led to increased demand for healthcare services in recent years. This has inspired strong growth rates within the global healthcare providers and services industry, which consists of healthcare facilities, healthcare distributors, healthcare services and managed healthcare services.

The managed healthcare landscape has changed with consumer preference moving towards lower priced and more flexible insurance alternatives. The substantial increase in the sale of catastrophic policies has confirmed a budding consumer preference towards policies with low premiums that offer cover at the extreme end of the pay scale, in the wake of spiraling health care costs. While this will reduce premium income, it should also substantially limit the number of claims, which can be regarded as a positive development providing companies prudently invest these increasing reserves to improve their investment returns while still demonstrating liquidity.

The industry is forecast to continue its strong performance although its growth is set to decelerate slightly, with an anticipated CAGR of 7.8% for the 2004-2009 period set to drive the industry to a value of \$5,250.2 billion by the end of 2009. The spiraling global population and

the rapid economic progression of the Asia-Pacific region will be the industry's primary drivers of growth moving forward.

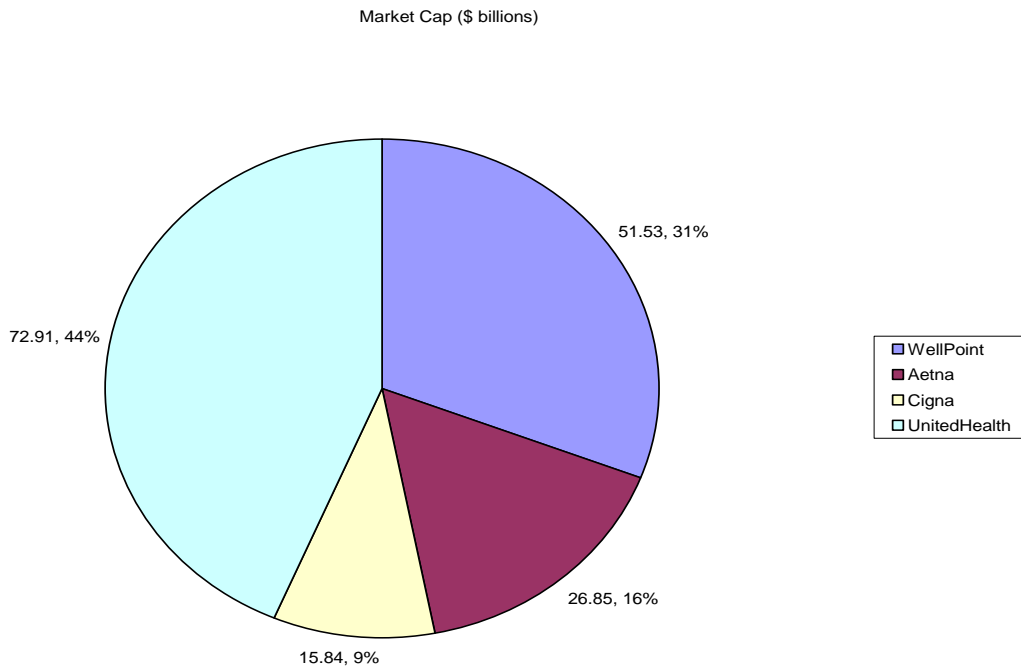
Industry in current economic environment⁹

One must first assess the current economic environment to then determine how the industry and thus WellPoint will properly react. The current state of the economy is rather ambiguous. In my opinion, we are moderately "overheating". An inverted yield curve is indicative of an overheating economy. As it stands now, the yield curve is quite interesting, as it is inverted and then retakes in historical shape in the long term. Moreover, I believe inflation will remain at its current levels or rise and growth indicators will start to slow as well. This would then set the economy up for a "hard landing". Growth will slow, but inflation will remain as companies raise prices to protect their margin against a rise in unit costs. This phase would end when commodity input prices fall or unemployment rises to bring wages under control. Historically, value defensive stocks (i.e. WellPoint with a beta of 0.65) have performed the best in this state of the economy. If history holds, then WellPoint will be well served in this state.

Company Position within Industry¹⁰

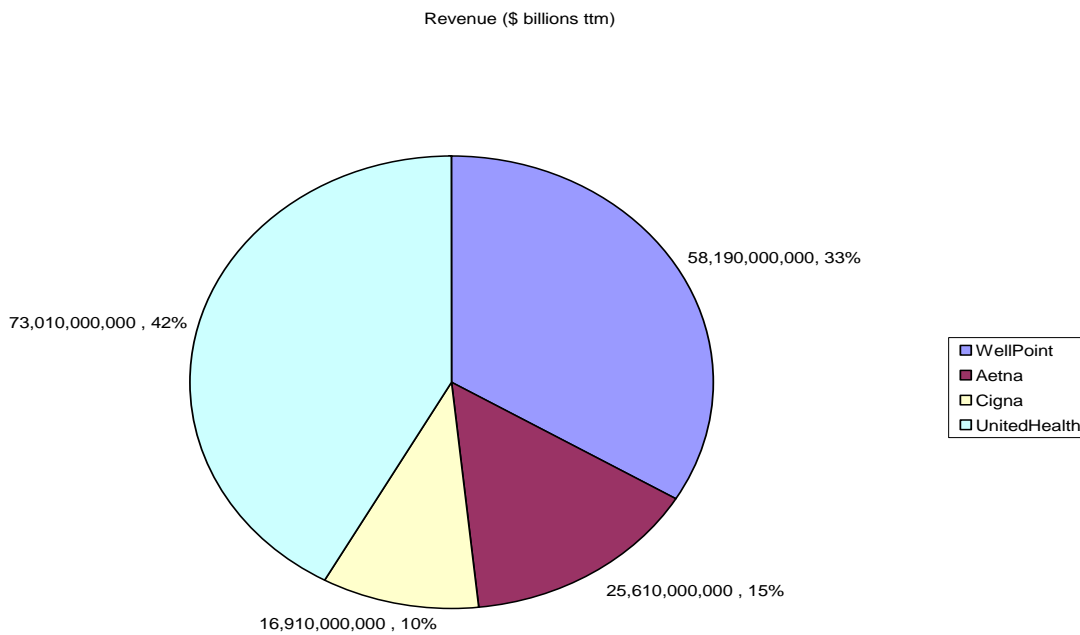
WellPoint's position within the health care provider industry sub-group is strong. As previously stated, it is the nation's leading health benefits company serving the needs of approximately 34 million medical members nationwide. Besides the number of members, it also boasts strong financial performance amongst its top competitors. Exhibits 2 – 4 compare WellPoint with its top 3 rivals: UnitedHealth, Aetna, and Cigna. These three companies are most relevant because of their similar size and structure, as well as the vast percentage of the market that they control.

Exhibit 2



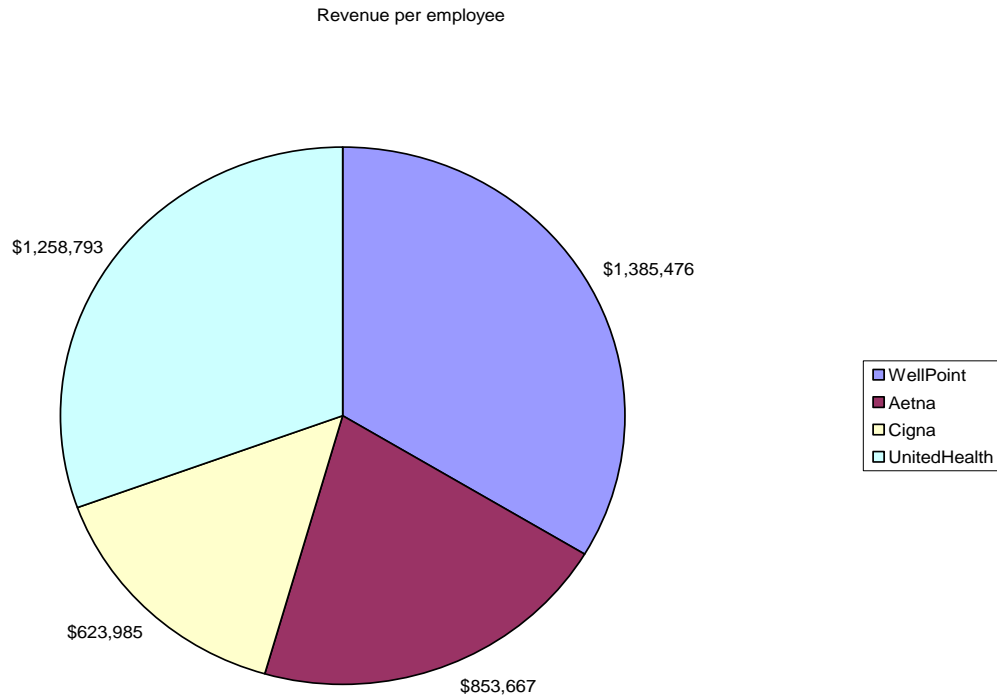
Notice in the following exhibit that WellPoint is not the leader in 2006 yearly revenue. Part of this is attributed to UnitedHealth’s revenues coming from areas other than health plan subscriptions.

Exhibit 3



Even more telling is WellPoint's revenue per employee. It is a sign of its productivity that it outstretches all its main competitors.

Exhibit 4



Growth Drivers

Through its many programs and initiatives, WellPoint is poised to take advantage of the changing demographic conditions (see page 4) to sustain high levels of growth and success.

General Healthcare Spending ¹¹

Driven by increasing health consciousness and adoption of new technologies available for treatment, healthcare expenditure in the US has increased steadily in recent years. The total US healthcare spending was estimated to have grown by 7.3% in 2005. The US healthcare spending is expected to grow by an average of 7.4% annually from 2006 through 2008 and by

6.9% annually from 2009 through 2014. WellPoint could leverage its strong network-based health plans and other health care-related products to exploit this growth in healthcare spending.

New Programs and Initiatives¹²

To capitalize on the growing need for healthcare, WellPoint has recently developed many successful new programs that are designed to lower costs, drive new memberships, and increase satisfaction for existing members.

360° Health

The company's 360° Health program offers a full range of support and services to meet the needs of each individual member. The aim of 360° Health is to help the 20 percent of its members with chronic conditions better manage their circumstances, and to help improve and maintain health for the other 80 percent. 360° Health is the first program in the healthcare industry to integrate all care management programs and tools into a single resource. Whether their medical needs are minimal or intense, 360° Health provides each of WellPoint's 34 million members with a broad range of personalized health care information and care management, delivered directly to them through innovative information technology and more than one thousand WellPoint nursing and health professionals. The result is improved health for its members, which also lowers their cost of care.

Consumer-driven health plans (CDHPs)

CDHPs help consumers take more control over their own healthcare. WellPoint is the first health benefits company in the nation to roll out an integrated CDHP portfolio across the country in all market segments, from the largest employers to individual members. The plans give members access to one of three types of individual health accounts that they can use to fund routine health expenses, including medications. Preventive services are fully covered. In

addition, each plan includes a traditional health coverage component to protect consumers in the event of large medical expenses.

The key to the success of consumer-driven health plans is providing consumers with cost and quality information to make informed decisions. CDHP consumers can locate nearby doctors and hospitals, compare hospitals on several quality and cost measures, compare prices of prescription drugs at local pharmacies, research common medical conditions and procedures, and estimate the costs of specific health care services. By providing innovative products and greater transparency, WellPoint is giving consumers more options and more tools to obtain affordable quality care.

ePrescribing

WellPoint is working with physicians and hospitals to harness the power of advanced information technology both to reduce administrative burden and to improve health care quality and safety. Fewer than 22 percent of physicians nationwide use the basic capabilities of electronic prescribing, which according to the Centers for Medicare & Medicaid Services, could eliminate as many as two million harmful drug events each year.

The company's Anthem Blue Cross and Blue Shield health plan in Ohio has launched a pilot ePrescribing program in two communities that will help reduce medication errors, improve patient safety, and cut the time physicians spend managing prescriptions and communicating with pharmacists.

Member Health Index

WellPoint is the first health benefits company to develop a Member Health Index to track progress in improving the health of its 34 million members nationwide. The Member Health Index tracks 20 broad measures in four areas: screening & prevention; care management; clinical

outcomes; and patient safety. Gains in these areas will mean that its members will have improved health and receive state-of-the-art care for their illnesses.

Restructuring

WellPoint reorganized its structure in late 2006 from a region-based node system to a nationwide, customer-focused strategy. The structure capitalizes on WellPoint's unique competitive advantage: the scale and scope to develop innovative products and programs for consumers, and the local leadership and knowledge to adapt those innovations to local markets across the country.

This approach allows for it to offer consumers from coast to coast an unparalleled choice of health care plans, and a full range of benefits and services. The new structure allows for the company to engage health care professionals in communities across the country in innovative programs to improve quality and reduce costs.

Company Management

Effective June 1, 2007, Angela Braly will become the new President and CEO of WellPoint. Her selection is indicative that WellPoint's training of its future leaders is proving worthwhile. Her rise through the company honed her intellect, health policy knowledge, business experience and strategic vision. This successful road map of training executives will be vital to WellPoint achieving its vision of transforming health care and becoming the most valued company in its industry.

Risks and Concerns

Like any company, WellPoint is not free of risks. Because of this, there are some substantial concerns that need to be addressed.

Intense Competition¹³

As noted earlier, WellPoint faces competition from not only small health benefit companies, but larger corporations such as UnitedHealth, Aetna, and Cigna. Wellpoint operates in a highly competitive environment and in an industry that is currently subject to significant changes from business consolidations, new strategic alliances, legislative reforms, and aggressive marketing practices by other health benefits organizations. As information becomes more and more readily available, WellPoint is facing increasing market pressures brought about by an informed and organized customer base, particularly among large employers. This competitive environment is likely to continue to produce significant pressures on the profitability of health benefits companies such as WellPoint.

Regulation¹⁴

Much of WellPoint's business could be adversely affected by changes in state or federal regulations. One example of this was previously mentioned on page 4 in regards to the Medicare Part D Prescription Drug Plan. Further examples can be seen in recent actions of state legislatures. States such as California, Connecticut, and Pennsylvania are contemplating significant reform of their health insurance markets. These proposals include provisions affecting both public programs and privately financed health insurance arrangements. These proposals attempt to increase the number of insured by raising the eligibility levels for public programs and compelling individuals and employers to purchase health coverage. At the same time, they reform underwriting and marketing practices of health plans. In essence, a company such as WellPoint could be squeezed from both ends. It would face decreased margins by accepting lower paying members and also see its ability to profitably underwrite plans be diminished.

Regional Concentration¹⁵

Although it was correctly noted above that WellPoint recently restructured to capture nationwide synergies, it still derives much of its business from only 14 states. If economic conditions in these states deteriorate, the company may experience a reduction in existing and new business, which could have a negative material effect on its business.

Acquisitions¹⁶

The company has built a significant portion of its current business through mergers and acquisitions and it plans to continue this course of action in the future. There are risks associated with this strategy however. First, the company may be unable to integrate acquired businesses successfully and realize anticipated economic, operational, and other benefits in a timely manner, which could result in substantial costs and delays. Second, acquisitions could disrupt ongoing business and distract management. In doing so, resources could be needlessly diverted and it would be difficult to maintain current business standards, controls, and procedures.

Recent Earnings¹⁷

In its most recent earnings release (4/25/07), WellPoint missed revenue targets for the first quarter and simply matched bottom-line estimates. The company also raised its full-year guidance less than some people had hoped. First-quarter revenue increased 8.8% to \$14.8 billion, falling short of the \$15.1 billion consensus estimate, despite enrollment growth in most of the company's business segments. Membership in increasingly popular consumer-directed health plans jumped by 57% alone. Net income rose 7% to \$783 million, with earnings per share of \$1.26 matching Wall Street targets. The main concern for investors though was the company's medical cost ratio (MCR), measuring the amount of each premium dollar spent on patient care, climbing to 83.1% in the first quarter from 81.3% last year. WellPoint blamed most of that increase on businesses outside the commercial arena, which is the sector that worries investors

most. But it confessed to suffering an "unacceptably high" MCR in certain markets where it sells Medicaid plans - a key growth vehicle for the company - while vowing to remedy the situation. Indeed, WellPoint must look to remedy this problem or investors will continue to be concerned that rising medical costs will hinder free cash flow. If this trend is not corrected, investors will more than likely devalue the stock as profit increases will rely more and more on cost savings and share repurchases going forward.

Financial Analysis (see attached financial statements)

Understanding WellPoint's operational strengths, weaknesses, and environment does not paint the full picture. One must also dissect the company's financial statements to ascertain its true value.

Income Statement

In recent years, there have been two noticeable drivers of earnings growth for WellPoint. First is in regards to increased sales (or premium revenue) growth. Disregarding the completion of the merger with Anthem in 2005, WellPoint has seen its sales growth upwards of 25% on average the last five years. A second driver of earnings growth is the reduction in general and administrative expenses the last five years. It has decreased from 17% of sales in 2002 down to 12.7% of sales in 2006.

Balance Sheet

Over the last five years, the balance sheet has remained relatively stable except for one line item. After the merger with Anthem in 2005, WellPoint exponentially increased its long term available for sale investments. Of course, this money had to come from somewhere and it was seen in just as big reduction in its short term available for sale investments.

Cash Flow

Understandably, the most prominent source of cash flow from operations is the collection of cash from insurance premiums. WellPoint experiences an outflow of cash from investing activities primarily due to its purchases of fixed securities outweighing the proceeds from selling fixed securities. Historically, WellPoint would experience an inflow from financing activities because its proceeds from long-term borrowings were greater than its repayments on those borrowings. However, in 2006 WellPoint repurchased \$4.5 billion worth of stock which reduced cash from financing, but ultimately raised EPS figures.

Dupont Analysis

The Dupont Analysis below for the last five years provides sound indication on WellPoint's operational effectiveness and its capital structure.

Exhibit 5

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Profit Margin (EBIT/Sales)	6.93%	8.15%	7.79%	9.37%	9.48%
Asset Turnover (Sales/Assets)	1.058	1.229	0.512	0.856	1.083
Return on Investment (PM * AT)	7.33%	10.01%	3.99%	8.03%	10.27%
Leverage Multiplier (Assets/Equity)	2.293	2.236	2.042	2.052	2.106
Return on Equity (ROI * LM)	16.80%	22.39%	8.15%	16.47%	21.64%

These ratios are all very telling. All ratios improved until 2004. During this time, WellPoint was going through its extensive merger and acquisition of Anthem. The decrease in effectiveness across the board can be attributed to this divergence of resources during the year. However, the company seems to have come out of the merger stronger than ever and is capturing the synergies proposed by the original deal. Its ratios have increased across the board as the company has increased its operational effectiveness (see PM, AT, and ROI ratios) while maintaining a sound capital structure (LM) and raising its return to investors (ROE).

Valuation¹⁸

Many valuation methods were refined and implemented to arrive at a sound judgment of WellPoint's target price. These methods included: absolute valuation, valuation relative to S&P 500, valuation relative to healthcare sector, and valuation relative to three main rivals (UnitedHealth, Aetna, Cigna). Also, a discounted cash flow (DCF) model was derived to compare to the above multiple valuation with the goal of arriving at a sound intrinsic target price.

Absolute Valuation

For the most part, WellPoint seems to be trading at or near its historic mean. Under the assumption of mean reversion, there is a little room for the price to increase towards its historic mean, but as it stands, the numbers are in line with market expectations. By taking an arithmetic average of the five target values, a multiples target price of \$87.32 is established.

Exhibit 6 (only 2002-2007 data available)

Absolute Valuation	High	Low	Mean	Current	Target Multiple	Target E, S, B, etc/Share	Target Price
P/Forward E	18.2	10.1	14.4	14.3	14.8	5.55	82.14
P/S	1.14	0.44	0.73	0.91	0.95	91.32	86.75
P/B	3.6	1.2	2.0	2.1	2.2	40.8	89.76
P/EBITDA	11.2	8.3	9.3	9.0	9.3	9.8	91.14
P/CF	17.6	13.8	15.2	14.8	15.1	5.75	86.83

Relative to S&P 500

The stock appears to be slightly expensive when compared to the SP 500, due to a majority of multiples tracking higher than the historic mean. If under the assumption of mean reversion, then these multiples will revert to their historic mean and the price will moderate. There is no indication that these multiples will continue their momentum and remain high.

Exhibit 7 (only 2002-2007 data available)

Relative to SP500	High	Low	Mean	Current
P/Forward E	1.19	0.61	0.90	0.93
P/S	0.78	0.25	0.47	0.66
P/B	1.37	0.39	0.67	1.34
P/EBITDA	1.39	1.10	1.25	1.25
P/CF	1.46	1.17	1.32	1.25

Relative to Healthcare Sector

Based purely on this basis, the stock looks to be inline with the sector, although I do not lend as much credence to these multiples as I do the absolute valuation of the stock (due to insufficient data). There are no indicators that the stock is a screaming buy or sell.

Exhibit 8 (only 2002-2007 data available)

Relative to Sector Valuation	High	Low	Mean	Current
P/Forward E	1.03	0.52	0.80	0.83
P/S	0.58	0.13	0.33	0.48
P/B	0.59	0.25	0.46	0.50
P/EBITDA	0.89	0.63	0.78	0.66
P/CF	1.12	0.92	1.05	0.96

Relative to UnitedHealth, Aetna, Cigna

Compared to its major rivals, WellPoint does not seem to be out of line. There are no indicators that the market is under-pricing the stock as its P/E is inline with the average of its three major rivals. The leading indicators for 2007 and 2008 also indicate that the stock will moderate in line with its competition.

Exhibit 9	(ttm)	P/E	
		2007E	2008E
United Health	18.12	15.8	13.8
Aetna	16.77	15.6	13.9
Cigna	16.08	15.2	13.5
Avg.	16.99	15.53	13.73
WellPoint	16.83	15.1	13.1

DCF Valuation

As noted, a DCF model was meticulously constructed to predict future cash flows and thus an intrinsic target price. The target price produced by the model was \$86.90. This is very similar to the multiple target price of \$87.32 and lends credence that both estimates are accurate.

The many assumptions that went into the DCF model are listed in the appendix with the DCF model itself.

Conclusion

After scrutinizing all available information and conducting an in-depth analysis, I can say with confidence that WellPoint is a ***HOLD*** stock. After equal weight averaging both the multiple valuation and DCF targets, I arrive at a final target price of **\$87.11**. Based off its current price of \$83.98 (as of 5/28/07), there is an upside of 3.72%, which puts it in the range of a hold strategy. I do not find this surprising. Both absolute and relative multiple valuation put WellPoint near its historic mean. Also, WellPoint is an established company in a defensive sector, so the market can efficiently price it. The following are the main reasons that allowed me to arrive at my conclusion to “hold” WellPoint

Positives

- *Market Leadership*: Principal competitive advantage is its scale as the largest health care company by number of customers in the US. Its number one market share in 13 of the 14 states in which the company operates increases its bargaining leverage with health care providers and its scale of operations allows it to offer health care at low cost.
- *Favorable Demographics*: By the year 2030 the number of elderly people is expected to climb to 71.5 million, or 20% of the total population. This increase in life expectancy will increase demand for healthcare services and more importantly, the demand for more innovative and sophisticated means of delivering those services. With 77 million baby boomers rapidly approaching an age when many will require long term care services, health care providers such as WellPoint would be able to provide them with quality care. With people living longer, there in turn would be an increase in healthcare spending. The US healthcare spending is expected to

grow by an average of 7.4% annually from 2006 through 2008 and by 6.9% annually from 2009 through 2014. WellPoint could leverage its strong network-based health plans and other health care-related products to exploit this growth in healthcare spending.

Negatives

- *Intense Competition:* WellPoint faces competition from not only small health benefit companies, but larger corporations such as UnitedHealth, Aetna, and Cigna. As information becomes more and more readily available, WellPoint is facing increasing market pressures brought about by an informed and organized customer base, particularly among large employers. This competitive environment is likely to continue to produce significant pressures on the profitability of WellPoint.

- *Regulation:* Much of WellPoint's business could be adversely affected by changes in state or federal regulations. A prime example of this is the Medicare Part D Prescription Drug Program for senior citizens. Profit margins for this government sponsored program are expected to be in the 4-6% range for most insurers. This is significantly below the 6-12% profit margins for more traditional health care products. This would put downwards pressures on the margins which are already low. Medicare Part D would also cannibalize drug coverage provided by dual eligible Medicare/Medicaid recipients, Medicare Gap insurance products and other products like drug discount cards as it would replace them in few instances. Regulation like this that is aimed at making healthcare more affordable will negatively impact WellPoint unless it can drastically reduce its costs. As noted in recent earnings releases, these costs are already starting to increase.

In summary, the positive and negative factors facing WellPoint balance each other out. There is no one catalyst that is triggering a massive reaction to buy or sell. The economic conditions facing the company are uncertain due to the ever present threat of regulation.

However, the demographic trends are a positive in its favor. The company's financials are solid as well and should grow in line with estimates. Based on my numerous valuations, the stock is fairly priced and would perform relatively well enough in the event of an economic downturn due to its defensive nature. With that said, I once again affirm my "hold" status of the stock.

Endnotes

1. adapted from WellPoint Inc. website (www.wellpoint.com)
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