Investors Alley
March 2015 Vol. 1 Issue 3
Bret Jensen's Blue Chip Gems

February Shows Why We Build the Portfolio Slowly

Fellow Investor,

After a huge February, equities have given back some of their strongest monthly gains in a few years over the first couple of weeks of March.

The S&P 500 stands roughly flat for year as we publish this month's issue of Blue Chip Gems.

Oil, after rallying almost to $55 a barrel on West Texas Intermediate, has fallen back below $45 a barrel and no one is confident in predicting a bottom right now. The whole energy complex is murky and volatile here and its movements are bringing additional volatility to equities. This is something I see continuing at least through the second quarter and will be discussing at the MoneyShow in Las Vegas in May. See the postscript at the bottom for details.

In This Issue

The other big theme that is accelerating is the strength of the US dollar. This is causing severe headwinds in major emerging markets like Brazil as well as the commodity markets. More importantly for domestic stock investors, the strong dollar is starting to badly crimp the earnings of American multinationals that get a good portion of their revenues from overseas.

This is particularly true of companies that see a lot of their demand from Europe such as **McDonalds (NYSE: MCD)** and **IBM Corporation (NYSE: IBM).** The Euro has dropped some 25% from its recent highs this summer and stands at roughly $1.06 to the dollar. This is a twelve year low. Goldman Sachs came out earlier this month and stated it could see the Euro eventually reaching just 80 cents to the dollar by 2017. This is great if you are planning a European vacation but not so good for the profit picture in the first half of 2015 if you're an American company with significant business in Europe.

The plunge in crude prices and its impact on profits in the energy sector as well as the strong dollar's impact on some of the biggest companies in the major indices is having their effect. Earnings estimates for the S&P 500 have been revised sharply down over the past few months for the first half of 2015. The consensus now has profits in both the first and second quarter of this year as down slightly year-over-year.

Analysts tend to revise estimates down into the quarterly reporting season providing a low bar companies can step over when they actually report results. I call this the "analyst two step" and it is a long standing Wall Street tradition. I expect earnings to come in a bit better than the current consensus. However, even with that small bit of optimism earnings look to be flat at best year-over-year for first six months of 2015.

With the market trading at 18 times trailing earnings and the Federal Reserve looking to raise interest rates for the first time in nearly a decade by the end of summer the environment looks tepid at best for U.S. equity investors. This is especially true as fund managers appear to shifting some of their fund allocations to European equities to take advantage of the recently initiated quantitative easing efforts by the European Central Bank.

This is why we will continue to build our Blue Chip Gems portfolio two stocks at a time until we reach our optimum portfolio size of 20 best of breed companies that are trading at reasonable if not attractive levels. There is a strong possibility we might get some lower entry points in the months ahead. We will also continue to avoid for now firms with significant exposure to crude prices or the strong dollar.

If you ever have a question or comment you can reach me at bret.jensen@investorsalley.com.

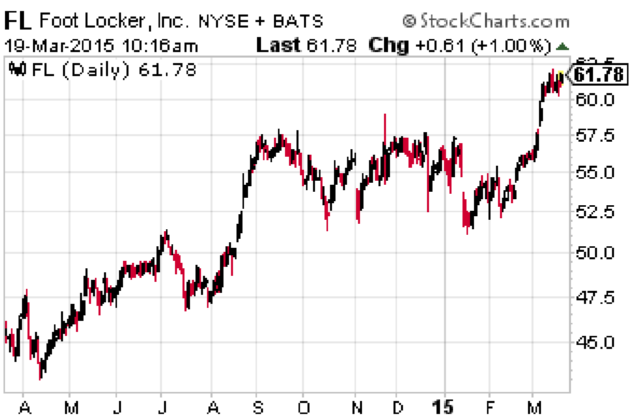
Thank you and Happy Hunting.

Bret Jensen
Editor
Bret Jensen's Blue Chip Gems

P.S. I'll be a key presenter at the Las Vegas MoneyShow running May 12th through May 14th. I will present on two topics: one on biotech investing and the other on making sense of the energy markets. This is a great opportunity for you to get in-depth information on both subjects and ask questions. At the last show in Orlando the room was almost at capacity and I expect both presentations to fill up quickly this time. If you live in the Las Vegas area or plan to be there or just need an excuse to visit **click here for more information and to register for free.**

Foot Locker: Best of Breed Footwear Retailer

Our first addition this month is the number one sports shoe retailer in the world, **Foot Locker (NYSE:FL).** It is our first foray into retailing which has some emerging positive trends that should be in place for the foreseeable future. Although the stock sells near 52 week highs, valuations are still reasonable and it is a stock I have been slowly accumulating during the assorted dips the market has provided so far in 2015.



This is going to be steady grower both in revenues and earnings, provides a solid and growing dividend and should remain the market leader in its space for the foreseeable future. Most importantly, I like the shares to outperform the overall market in total shareholder returns over the next three to five years.

Top Dog in Space:

Foot Locker owns and operates just under 3,500 stores worldwide under brand names including Foot Locker, Lady Foot Locker, Foot Action, Champs and Kids Foot Locker which provide just over $7 billion in annual sales currently. To put in perspective, the number two pure play in the space is **Finish Line (NASDAQ: FINL)** which has under 1,000 stores and under $2 billion in annual revenues. Foot Locker is the true 800 lb. gorilla in the space. This helps it get better allocations and terms for hot shoe lines from giants like **Nike (NYSE: NKE)**, **Under Armour (NYSE: UA)** and **Adidas**.

In addition, the company has invested sufficient time and resources developing various e-commerce platforms for its brands. These investments have paid off as the company's efforts in this area have resulted in the best web properties in the space according to most analysts. It is also showing up in results. In the last completed quarter, e-commerce revenues were up better than 20% year-over-year and have become a core part of the Foot Locker's overall business.

A History of Delivering Results:

The company's e-commerce initiatives are not the only thing to admire about Foot Locker. The company has done a stellar job delivering the goods for several years now. Foot Locker has now delivered 20 straight quarters of significant revenue and earnings growth. During that time span, same store sales have grown from the mid to high single digits thanks primarily to the company's prominence in the basketball and running shoe arenas.

Foot Locker and Nike are very important to each other as the main manufacturer and retailer in the athletic footwear space. The combination is particularly strong in the basketball shoe category where retro Jordan, Lebron, Kobe and Kylie Irving branded shoes are showing strong results. The company is also developing a deeper relationship with up and coming Under Armour which is just getting into the footwear category and its Steph Curry shoe is blowing out according to Foot Locker's last conference call. There is some speculation that Under Armour may develop a "store within a store" concept with Foot Locker which would be a positive catalyst.

Foot Locker seems to beat the consensus bottom line estimates every quarter in recent years. In early March the company delivered earnings per share of $1.00, nine cents a share above expectations. Revenue also came in $40 million above the consensus and was up nearly seven percent year-over-year. It was the sixth straight quarter the company has stepped over bottom line estimates. For the just completed fiscal year, the company delivered earnings of $3.58 a share, substantially above the $2.87 a share profit Foot Locker posted during its last fiscal year.

Not Resting On Its Laurels:

Despite stellar results over the past half-decade, this retailer is not resting on its laurels. The company is about 25% through a large renovation effort to remodel its stores. The new stores have larger selling spaces and more sales per square foot. This is helping margins. In its last completed quarter, the company reported gross margins of 32.9%, up 40 basis points year-over-year despite negative currency headwinds.

In addition, the company is in the process of installing an improved inventory system which should allow the retailer to make better allocation decisions as the system is installed globally, decreasing mark downs and improving margins. The company is also closing underperforming stores. For 2015, Foot Locker plans to close 80 stores while opening 100 new stores.

This optimizing of the portfolio has been a key driver to turning around results at Lady Foot Locker which has been challenged in recent years. This division has now posted three straight quarters of increasing comparable store sales with last quarter seeing double digit growth single store comparable sales. At a recent investor meeting the company stated it is slowly exiting the stand alone female apparel and footwear business and will continue to close Lady Foot Lockers as their leases expire. This will result in a more focused retailer and also help to improve operating margins as this franchise has been a laggard within the business for years. The company is executing a smart strategy to slowly exit the business which should minimize disruption.

The Trend Is Your Friend:

The company still gets the majority of revenues and earnings even considering a growing presence in Asia and a solid footprint in Europe. However, two things should help growth domestically: falling gas prices worldwide are acting for a “tax cut” for consumers globally. Some of that extra discretionary income should find its way into additional demand for the footwear and apparel which are Foot Locker’s bread and butter. The other is the employment picture in terms of job growth and wage growth.

Over the past 12 months the economy has created some 3.3 million new jobs. These are the strongest jobs numbers since 1999. Wage growth seems to be picking up as well recently. A strong jobs market and improving wage growth should also provide solid tailwinds for domestic sales growth as better consumer confidence eventually finds its way into stronger consumer spending.

Since Foot Locker pays commissions to its sales associates on top of regular wages, most of its employees are already earnings significantly over minimum wage. The company should not be impacted by minimum wage hikes in a variety of states or from that at competitors such as **Walmart (NYSE:WMT).** One concern is the strong dollar, this is legitimate but manageable. Earnings would have been 16 to 18 cents a share lower in the previous fiscal year as the current prevailing currency rates.

Rewarding Shareholders:

The company recently announced it is adding $1 billion to its stock repurchase program. Management has stated that it intends to execute this program over the next three years. This buyback would retire approximately 12% of the company’s outstanding shares at current price levels and boost earnings per share by a similar amount.

The company is also using its expanding free cash flow to pay an increasing dividend. Earlier in the year, the retailer boosted its dividend just over 13% to a quarter a share so that the stock now yields just a bit under two percent. Additionally, the company has doubled its dividend over the past seven year via a series of consistent hikes.

Valuation:

The stock is not dirt cheap at approximately 15 times this year's projected earnings. However, in a market that is trading at 18 times profits, the shares are reasonably attractive especially from a longer term perspective. The company should be able to increase earnings and dividend payouts at 10% or better annually for the foreseeable future on the back of revenue growth in the mid-single digits. Combined with improving sentiment on retailers, the stock is a good long term core holding and one that should be in the Blue Chip Gems portfolio for years to come.

Position: Long FL

Express Scripts: the 800 lb. Gorilla in Healthcare Will Continue to Roll

For our second selection for our third edition of the Blue Chips Gems newsletter we are adding another large player in the healthcare sector. This space has been one of the strongest performers in the market over the past few months and is likely to remain so for myriad reasons. Global demand and growth remains tepid but healthcare companies tend to grow within a set range regardless of what the worldwide economy is doing due to inelastic demand in the sector for the most part.

In addition, investors are increasingly willing to pay higher multiples for the reliable revenue and the earnings growth this sector provides, especially with profits from other industries like mining and energy producers and the firms that serve those customers collapsing. Finally, these firms tend to have less exposure to overseas markets which have started to crimp profits recently due to the accelerating strength of the dollar which currently stands at levels not seen in over a decade. This strength should continue as the Federal Reserve should raise rates at some point in 2015 while its counterparts in Europe and Japan pursue easy money policies.

Like **Foot Locker (NYSE: FL)** mentioned earlier, **Express Scripts (NASDAQ: ESRX)** is the market leader in its space where it is the largest pharmacy benefit manager in the world. Pharmacy Benefit Managers are commonly called PBMs. These companies are under contract with managed care organizations, self-insured companies, and government programs to manage pharmacy network management, drug utilization review, outcomes management, and disease management. A pharmacy benefit manager may, for example, fill drug prescriptions by mail order as part of a corporate health insurance plan. Their main attraction is they use their expertise and logistical prowess to police the pharmacy and drug space to help ensure costs grow at manageable rate. Express Scripts stated at its Investors Day that it saved its clients some $2.2 billion in 2014 with no impact to quality of care.

PBMs are becoming more critical to managing healthcare costs due to the growing stable of both lifesaving and maintenance type of drugs, some of which are astronomically expensive. In addition, as new advances in biotech and pharmaceuticals continue to be made and the population in developed nations continue to age drugs are making up a greater portion of the healthcare spending pie.

Express Scripts is the unquestioned market leader among the pharmacy benefit managers. In April 2012 the company acquired rival PBM Medco Health Solutions for some $29.1 billion in cash and stock, more than doubling its revenue base.

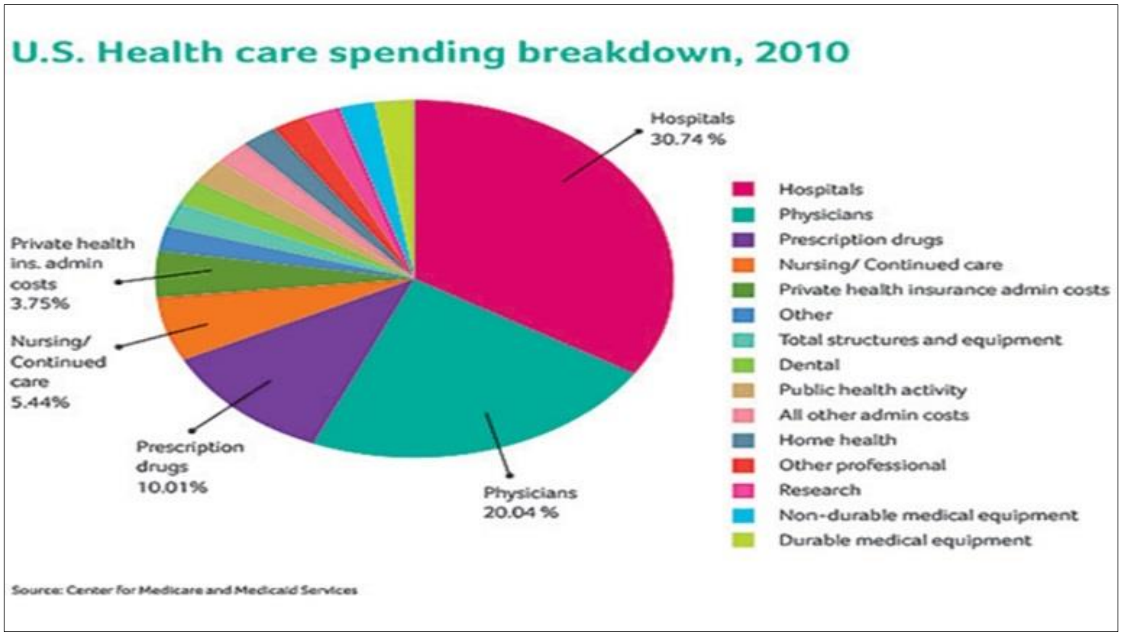
Spending on prescription drugs breached the 10% level for the first time in 2010 and has been growing consistently as a percentage of the total healthcare spending in the United States. This trend will continue for the foreseeable future as new specialty and personalized medicines come to the market in greater and greater numbers. Express Scripts expects spending on these specialty drugs will increase 50% throughout the system by 2018.

Prescription drug spending increased some 13% year-over-year in 2014, the largest increase in at least a decade. This growth was largely driven by new breakthrough treatments for hepatitis C and other conditions. Spending on these specialty medicines, such as those for inflammatory diseases, multiple sclerosis, cancer and hepatitis C rose an unprecedented 31% year-over-year.

be spent to address the symptoms of this disease that affects almost four million people in the United States.

Express Scripts is the 800 lb. gorilla in this space with the stock having a market capitalization just north of $60 billion and annual revenues above $100 billion. This is low margin business that relies on economies of scales and operating efficiencies which Express Scripts excels at more than any other player in the space.

The company carries huge and growing heft in the healthcare arena. When giant retailer **Walgreens (NYSE: WAG)** dropped Express Scripts as it did not want to agree to the company's terms on a new contract in



This is not necessarily a bad thing for overall healthcare spending. New drugs make seem costly upfront but used correctly can lower the overall costs of the healthcare system. For example, spending over $60,000 for a one pill a day twelve week regimen like Sovaldi to cure hepatitis C may seem excessive. However, the costs pale in the comparison to the $500,000 to $750,000 cost for the liver transplant some of these patients would be heading for in the future without this option or the thousands of dollars annually that need to

2011, the stock of Walgreens cratered as did its sales over the next year. When a new contract was signed in 2012 (largely on Express Scripts' terms), the shares of Walgreens shot up over 12% that day.

Express Scripts has the same influence with major pharma and biotech players. When the company announced new hepatitis C products from **AbbVie (NASDAQ: ABBV)** would be used exclusively to treat members in its network to treat certain types of hepatitis C the stock of hepatitis C market leader **Gilead**

Sciences (NASDAQ: GILD) took a significant hit. (Both AbbVie *and* Gilead are core holdings in the Blue Chip Gems portfolio.) Express Scripts was to leverage the competition between the two biotech giants to negotiate a huge discount from AbbVie to help slow the total costs within its network going to hepatitis C treatments. This is also one reason Express Scripts is now in the portfolio, it makes a nice offset to our stakes in Gilead and AbbVie.

Express Scripts plans to utilize these same tactics to tackle some of cost challenges in the cancer space which has seen a spate of high cost drugs in recent years. The company gets 14% of its revenues from the government market, 39% from the commercial space managing costs for companies, and the remaining 47% from engagements with health plans like Blue Shield & Blue Cross. Given the company's business is in the United States, Express Scripts is not being impacted by the strengthening dollar like the majority of the S&P 500 companies and this should make it more and more of attractive play for investors who want to mitigate this continuing currency trend.

The company's government business holds great growth promise especially with the passage of the Affordable Care Act and its impacts. Revenue from government programs like Medicaid and Medicare for Express Scripts have grown more than 1,000% since 2010 and the company is well equipped and positioned to manage the complexity of dealing with these government agencies and complying with their policies, audits and regulations.

Valuation & Summary:

As can be seen from the chart below, despite operating in a boring and low margin business this pharmacy benefit management behemoth has easily beat the returns of the overall market and been one of the best large cap growth stocks of the past decade.

As one might imagine given the company and stock's sterling outperformance over the past ten years, the shares are rarely cheap. However, given Express Scripts' steady growth and position as the market leader in a part of the healthcare market that carries growing importance the shares are still attractive from a long term investment perspective. This is an ideal holding to add a few shares to every time the overall market goes through one of its periodic pullbacks.

The company has a solid balance sheet and a free cash flow yield of approximately seven percent. Express Scripts should continue to grow earnings per share at 10% to 12% annually for the foreseeable future. The stock sells at just over 15 times forward earnings. This is a slight discount to the overall market multiple that the shares do not deserve given the company's consistency of earnings growth, record of delivering shareholder returns and Express Scripts' market leadership within the pharmacy benefits manager space.

Position: Long ESRX

Portfolio Update

As I pen the Blue Chip Gems portfolio update for March, the Dow Jones Industrial Average is in the middle of its seventh day of a triple digit move in the past eight sessions. As I noted at the beginning of this month's issue, there are several drivers of this increased volatility and markets are likely to continue to be very choppy over the next few months.

As could be expected given the topsy turvy nature of the market right, performance over the last month in the Blue Chip Gems portfolio was a mixed bag. Let's take a look at the current positions in the portfolio.

Apple (NASDAQ: AAPL) gave back a bit of its strong gains in 2015 during the month but fundamentals are extremely strong and the Apple Watch will roll out next month and the company just announced it is getting into television business with a web based streaming service.

Valero (NYSE: VLO) is down slightly since our last update but was recently the subject of some positive comments from Credit Suisse who noted the rising cash returns (dividends and stock buybacks) to shareholders.

JP Morgan (NYSE: JPM) performed well over the past 30 days as it passed the Fed's stress tests and raised its dividend by 10%. The company also plans to buy back over $6 billion of stock by the end of Q2 2016. Rising interest rates over the past month also buoyed sentiment on banks and insurers.

AbbVie (NYSE: ABBV) dipped earlier in March as it paid over $20 billion to acquire **Pharmacyclics (NASDAQ: PCYC).** Investors were initially turned off by the price the company paid for this biotech firm. However, the shares have recovered almost all of the decline from the first reaction as the blood cancer drug Imbruvica from Pharmacyclics looks like it is about to expand by being approved for additional cancer indications and could be a blockbuster in coming years.

Micron Technologies (NASDAQ: MU) had a tough month as **Intel (NASDAQ: INTC)** warned on tepid PC sales early in 2015. The first quarter is almost seasonally weak and I added a few shares on this month's pull back as the stock offers great long term value at present levels.

Las Vegas Sands (NYSE: LVS) has pulled back some 10% over the month as sales from Macau continue to decline as the Chinese leadership corruption purge is ongoing. I also added a few shares on this dip. At these levels, LVS has a five percent yield which should put a floor under the stock. Monthly sales comparisons should also get easier as we get further into 2015. In addition, **MGM Resorts International (NYSE: MGM)** has shot higher recently as activists push a real estate investment trust structure at the casino concern. This may make Las Vegas Sand consider the same structure for a spinoff of its large luxury retail properties which could unlock significant shareholder value.

Finally, **Gilead Sciences (NASDAQ: GILD)** continues to be in the same narrow trading range it has been stuck in for about nine months now. The shares are cheap here at just over 10 times forward earnings. The next catalyst could come in late April when the company reports quarterly results, earnings are expected to be up 50% year-over-year.

This month we add two new additions to our portfolio. Both are "best of breed" plays within their respective spaces that offer reasonable valuations in what remains a slightly overbought market. Both should do very well for long term investors and should remain core positions within the portfolio for the foreseeable future.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Returns	S&P 500 Comp.
Express Scripts (ESRX)	03/18/15	$83.29	$83.29	N/A	N/A
Foot Locker (FL)	03/18/15	$61.17	$61.17	N/A	N/A
AbbVie (ABBV)	02/13/15	$58.05	$59.89	3.2%	0.1%
Valero Energy (VLO)	02/13/15	$58.60	$61.96	5.7%	0.1%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$100.28	-0.4%	4.0%
Micron Technologies, Inc. (MU)	01/16/15	$28.99	$28.16	-2.9%	4.0%
Apple Inc. (AAPL)	01/16/15	$105.99	$128.47	21.2%	4.0%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$61.75	10.4%	4.0%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$54.80	-0.2%	4.0%

Notes:

Entry price is determined by the last "Close" price at the closing of the market on the day before publication. Recent price is determined by the last "Close" price at the closing of the market on the day before publication; most recent update: 03/18/15. Returns is share price appreciation or depreciation between entry price and recent price. S&P Comp. represents the returns on the S&P 500 Index from the point of entry of a stock listed above through the recent price and is meant to provide a comparison to the overall small cap stock market as comprises that index.

This is not real-time data and should not be interpreted as such.