Investors Alley
April 2015 Vol. 1 Issue 4
Bret Jensen's Blue Chip Gems

M&A Growth, Slowing IPO Activity, and a Strong Secondary Market

Fellow Investor,

The market has spent most of the time since our last update marking time with the S&P 500 slightly up. First quarter earnings reports have started to trickle in starting with **Alcoa (NYSE: AA)**. This will be the first quarter in quite some time that earnings are projected to decline year-over-year. A trend expected to continue in the second quarter before forecasted brighter skies for profits in the third quarter.

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The main drivers of this disappointing profit forecast continue to be a strong U.S. dollar, plunging crude prices decimating profits in the energy sector, and a tepid environment for global growth. The recent dollar strength has paused over the last few weeks. Not surprisingly gold, oil, and other commodities have done better recently. 10 year Treasury yields continue to post under two percent returns as yield is harder than ever to come by.

Greece continues to be the thorn in the side of Europe which has had a great year so far with equities. I believe eventually there will be a “Grexit” as Greece leaves the European Union. However, the continent is in a much better position to weather this potential event than it would have been in 2010 or 2011.

Merger and acquisition (M&A) activity is picking up recently. Heinz did a major takeout **of Kraft Food Group (NYSE: KRFT)** early in April**.** Shell did a $70 billion acquisition of BG Group and **Mylan (NYSE: MYL)** did an almost $30 billion purchase of rival Perrigo **(NYSE: PRGO)** as well. Even **General Electric (NYSE: GE)** has gotten into the act announcing it will sell most of GE Capital and buy back some $50 billion of stock.

To me this is a two sided coin. On one hand, increased M&A activity can bolster current stock market returns. On the other hand, when activity reaches these levels it often marks the top of the market à la 2000 and 2007. Also interestingly, the IPO market has dried up recently even as the secondary market has remained strong, especially among small biotech companies. This is worrying as about this time last year, the secondary market in small exploration and production companies was also robust and we all know how that turned out.

On the brighter side, this is exactly the type of environment that companies with consistent revenue and earnings growth that sell at reasonable valuations are more valued in what I believe is an overbought market. This is reflected in the solid overall performance of the nine Blue Chip Gems that so far have been added in our optimal portfolio. In this month’s Blue Chip Gems newsletter we add two more large cap growth stocks that should reward investors with a long term investment horizon.

On a final note, if you have not yet registered for the Las Vegas MoneyShow running May 12th through May 14th you need to do it now. Here' the link. I will be a featured presenter and will host workshops 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, ask questions, and meet other Blue Chip Gems subscribers. 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 then **click here for more information and to register for free**.

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

Capital One: Upping Our Stake in Financials

Our first pick for the April issue of Blue Chip Gems comes from the financial sector as I believe it is a good part of the market to increase allocation slightly to at the moment. A strengthening job market should continue to improve credit quality meaning write offs across the industry should continue to trend down as they have been doing for many years since the financial crisis ended. In addition, interest rates should start to head up at least a little higher in 2015 as the Federal Reserve has ended its quantitative easing programs and we should see our first rate hike from the institution since 2006 sometime this year. This would be good for banks' net interest margins and for returns on insurers' investment portfolios.

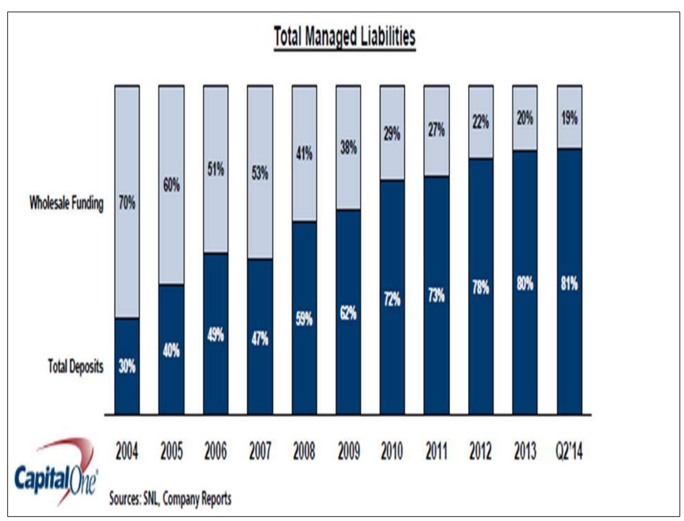
Auto sales and related financing remains strong and the housing market heads into the spring selling season and we should see increased activity in this space this year. Most importantly the financial sector sports reasonable valuations in a market that is feeling more and more "overbought". While the overall market is trading at approximately 18.5 times trailing earnings, many strong financial companies have stocks that are trading at 10 to 12 times earnings.

There are reasons for this discount. New regulations and increased regulatory focus and fines have increased compliance costs and led to reluctance to lend at levels we would ordinarily see at this point in a recovery or business cycle. In addition, this has been by far the weakest post war recovery of the ten cycles since 1945 as far as GDP growth.

However, it does appear the economy is slowing strengthening and regulatory action should have hit a peak and start to ebb some bolstering sentiment on the sector. We want to benefit from these trends at Blue Chip Gems and are adding **Capital One (NYSE: COF)** to our wallet or portfolio. Citi recently called Capital One its top pick among the credit card firms citing the company's "strong card loan growth, capital return, and reasonable valuation". It is an outlook I concur with at the moment. Let's take a look at the investment case for Capital One and why it belongs in the Blue Chip Gems portfolio right at $80.00 a share.

Company Overview:

When most people think of Capital One, they see a pure play credit card insurer thanks significantly to the company's well received and iconic "What's In Your Wallet?" campaigns. However, the company is much more than that. Thanks to some key banking acquisitions including ING Direct in February 2012, the company has transformed itself into a top 10 bank based on deposits. This significantly lowered its cost of funds base. A decade ago low cost deposits made up only 30% of Capital One's funding base and the rest was provided by more volatile wholesale funding system which can tend to dry up or get very costly in times of crisis or turbulence. Today over 80% of the company's funding needs are provided by its deposit base.



Capital One offers a broad spectrum of financial products and services to consumers, small businesses, and commercial clients. The company has just over $200 billion in outstanding loans on the books as the close of business at yearend 2014. Approximately 37% of these were credit card receivables, 24% were commercial loans (approximately 50% for real estate), 18% auto loans, and 14% home loans.

Capital One has been able to diversify its business lines and mitigate risk to any one segment of the economy over the past few years. It even has an online brokerage business. In addition, its exposure outside the United States is minute, thus removing any impact from a strong U.S. dollar that has been crimping the earnings of many firms within the S&P 500 with overseas reach over the past couple of quarters.

Growth and Balance Sheet:

Capital One is prudently growing its outstanding loan balance as the economy continues to slowly improve. In the fourth quarter, commercial loans grew 13% year-over-year and credit card loans increased six percent over the same time period as a year ago.

The bank recently passed the latest round of annual “stress tests” that have been a hallmark of the post crisis banking regulatory regime. The minimum Tier 1 common capital ratio for banks is 5%, according to the Federal Reserve. Capital One had a Tier 1 capital ratio of 9.5% up from 7.8% last year under the central bank's severely adverse scenario this year.

More importantly for the bank, it received permission to increase its dividend payout by a third to 40 cents a share a quarter. This will boost Capital One’s dividend yield to two percent. Given the payout ratio based on next year’s earnings is just 20% this dividend payout could be frequently and significantly boosted higher in coming years as the clamps start to come off the banking sector over the medium term as balance sheets continue to be in much better positions since the financial crisis. In addition, the company recently boosted its stock buyback authorization to just over $3 billion which is just under 8% of its outstanding float. The company bought back five million shares or roughly $400 million worth of shares.

Valuation:

The shares are cheap priced right at book value. The stock sells for less than 11 times trailing earnings in an overall market that goes for over 18 times trailing earnings at the moment. The company is always seeing solid revenue growth in a market seeing little organic sales gains at the present time. Revenues should increase in a five to six percent annual range over the next few years according to the current consensus and recent historical comparisons. Earnings should be flat to slightly up this year in the $7.50 to $7.75 a share range.

Next year should see an improvement to $8.00 to $8.50 a share according to most analysts I have seen. Profits should come in on the high end of that range if the economy produces closer to three percent GDP growth in 2015 and 2016; this is the current economic consensus rather than the two percent annual GDP growth the economy has seen throughout the recovery from the financial crisis. If interest rates do start to rise then sentiment, profits and multiples on the financial sector should all be boosted.

Summary:

Capital One is not going to set anyone’s portfolio on fire over the next year. However, the shares are undervalued at current levels from a longer term perspective. Given the company’s diverse business lines, projected better environment for financials over the next twelve months and low valuations the market multiple could easily improve to a conservative 12 times forward earnings. At the low end of FY2016’s projected profits of $8.00 a share that gets us to a $96.00 a share price target on Capital One. Add in a small but growing dividend yield and Capital One could easily return 20% over the next year. Given I think the overall market will be lucky to produce an overall return of mid to high single digits over that same time period and the company's position within the sectors it competes, Capital One is a compelling and low beta investment at current levels.

This is right at the current price targets of Barclays and Oppenheimer. After spending most of the last year in a relatively boring trading range, Capital One should be trading somewhere in the $90s by this time next year.

Recommendation: Buy COF at up to $85.00 a share.

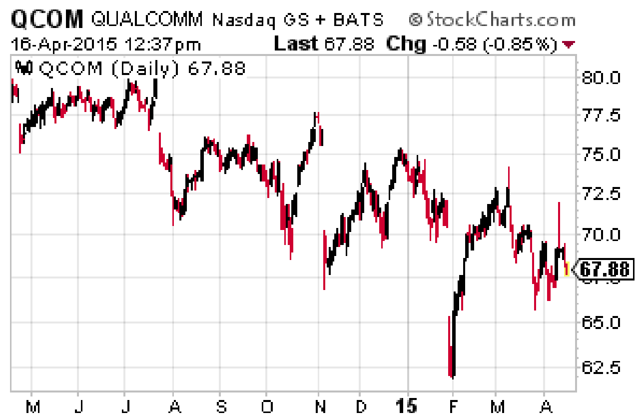
Position: Long COF

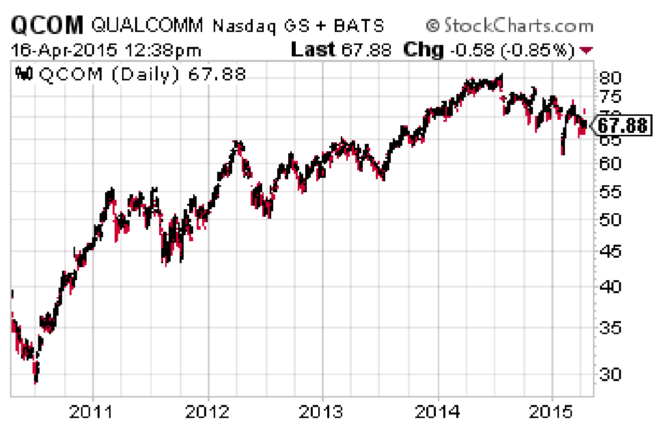
Qualcomm: Cheap and in the Crosshair of Activist Investors

Our second selection for this month's issue comes from the technology sector. It will be the third selection from this part of the market. **Apple (NASDAQ: AAPL)** was one of our inaugural picks due to its dominance in the smartphone space, stickiness provided by its huge and growing ecosystem, immense free cash flow, and attractive valuations. **Micron (NYSE: MU)** was selected due to its cheap valuation, changing dynamics in the DRAM space, and improved NAND product line. The shares have been under pressure due to poor guidance from others in the chip industry as well as tepid demand in the first quarter for PC sales. The shares have held considering this and are one of the cheapest plays in the market right now.

Our next pick from this sector is **Qualcomm (NASDAQ: QCOM),** the giant chipmaker that basically is to the smart phone industry what Intel (**NASDAQ: INTC)** is to the personal computer and server businesses. This company has been under pressure of late for several reasons.

The stock has seen significant headwinds recently as have most chipmakers. The stock is down some $10 a share over past twelve months to just under $70.00 but has been a solid performer over the past half-decade. The company seems to have been left out from the build of the new Galaxy 6 smart phone and has some issues with Chinese regulators in 2015.





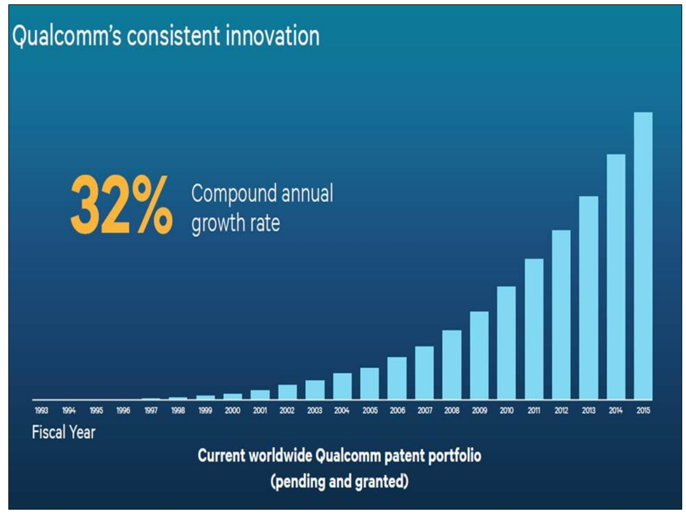
However, the decline has left valuations at attractive levels. The company is returning a great deal of free cash flow to investors in the form of dividends and increased buybacks. The company also has a great balance sheet.

Finally, a well-known activist fund has taken a big stake in Qualcomm and has already indicated it plans to push hard for significant changes at the chip giant that it believes will unlock substantial shareholder value in coming years. Let's take a look at the investment case for Qualcomm.

Company Overview:

Qualcomm consists of two main businesses. First it develops and supplies integrated circuits and system software based on code division multiple access (CDMA), orthogonal frequency division multiple access (OFDMA), and other technologies for use in voice and data communications, networking, application processing, multimedia, and global positioning system products. Qualcomm is the world's largest maker of chips used in mobile phones.

The second core part of Qualcomm's business makes use of the company's huge store of patents thanks to its hugely successful research and development (R&D) efforts over the years. This segment grants licenses or rights to use portions of its intellectual property portfolio, which includes patent rights useful in the manufacture and sale of various wireless products, such as products implementing CDMA2000, WCDMA, CDMA TDD, GSM/GPRS/EDGE, and/or OFDMA standards, as well as their derivatives. Approximately two thirds of the company's revenues come from this licensing and royalty business which requires much less capital expenditures than the manufacturing side of the business.



Recent Challenges:

The stock has been dogged because of problems with Chinese regulators, slower revenue growth, and its new chipset called "Snapdragon" not being a part of the new Samsung Galaxy 6. The company recently settled the antitrust investigation by agreeing to pay $1 billion in fines and modifying its royalty rates on handsets sold in the country. Unfortunately, this sort of "shakedown" is part of doing business in the Middle Kingdom for technology firms. The settlement puts the matter behind Qualcomm and hopefully will lead to more accurate license royalties by Chinese firms that use Qualcomm's products and patents.

Revenue growth has slowed into the low single digits year-over-year recently but the company has longer term opportunities that should boost sales back into the high single digits in the near future. I view the Snapdragon loss due to Samsung wanting to use a chip it manufacturers internally that is unlikely to affect other smart phone makers' decision to include Snapdragon in the future.

Longer Term Opportunities:

While growth in its core smart phone market has slowed recently, the market is far from saturated. Thanks to emerging markets, the smart phone market should still see solid unit growth for years to come. In addition, the world is becoming more and more "interconnected". Qualcomm's expertise in LTE and other mobile technologies should play well as homes and autos connect directly to the internet and become "smart". The company believes these new areas of growth will be key drivers to its goals to deliver average annual revenue growth of 8% to 10% over the next five years. It believes combined with stock buybacks and other operational improvements this will lead to annual earnings per share growth in the low teens over that same time span.

Valuation:

Qualcomm has a market capitalization of approximately $115 billion. The company has a fortress balance sheet with over $15 billion in net cash. The stock goes for less than 15 times trailing earnings in a market that currently goes 18.5 times trailing earnings. The shares go for less than 13 times next year's earnings and looks even better from a valuation basis when one equates for the net cash the company has on its books and considers its substantial dividend yield.

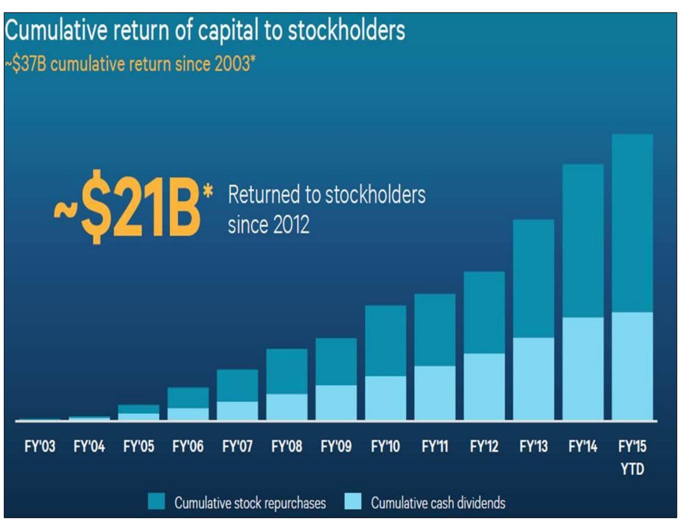
Rewarding Shareholders and New Activist Stake:

Recently Jana Partners has taken a better than $2 billion stake in Qualcomm. Jana is one of the oldest and most successful of the large hedge funds in the activist space. This represents a good portion of Jana's current investment portfolio. Already Jana is calling on Qualcomm to cut costs, accelerate stock buybacks, and

make changes to its executive-pay structure in an effort to improve shareholder returns.

Jana could also call on the tech giant to break itself into two separate business lines along the current core dual parts of the company. Both of the separate firms could command greater multiples in the market as pure play entities. Qualcomm itself proposed this idea 15 years ago but later called it off. An announcement to split the company into these two separate entities could quickly add 20% to 25% in market capitalization as the move would be very well received in the market. Another possibility would be for Qualcomm to sell its chip business to a larger entity like Intel which could also unlock significant value.

The company was already stepping up its largesse to its shareholders before Jana took a stake. Qualcomm announced $15 billion stock buyback announced last month, with $10 billion set to be repurchased in the next 12 months. The company also raised its dividend payout 14% recently and the stock now yields over three percent, an appealing trait for income investors in this low interest rate environment. Qualcomm has been returning more and more of its free cash flow to shareholders in recent years and gave back over $7 billion to stockholders in dividends and stock buybacks last year.



Summary:

Qualcomm is the classic Blue Chip Gem stock that has temporarily hit some rough waters over the past year. The shares are cheap, the stock pays a substantial dividend, Qualcomm should boost growth in the years ahead, and has a big activist fund pushing it to create additional shareholder value.

The shares deserve at least a conservative multiple of 15-16 times the $5.50 a share the company is projected to make in 2016 which gives me a price range of $81.00 to $87.00 a share on QCOM. Add in a three percent plus yield plus the possibility of the company splitting into two companies and the stock should easily outperform the market over the next 12-18 months and should be the kind of consistent deliverer of shareholder value that the Blue Chip Gems portfolio stocks seeks out.

Recommendation: Buy QCOM up to $73.00

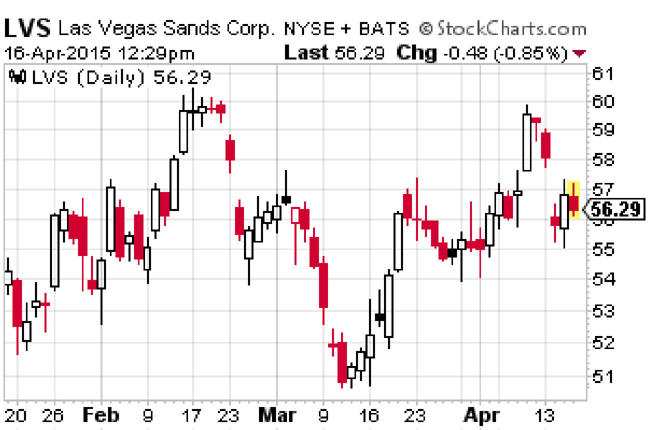
Position: Long QCOM

Portfolio Update

Our budding Blue Chip Gems portfolio put in a solid performance since our last update despite the stock market showing some volatility and being slightly up over the past four weeks. The new additions to our portfolio did well since their recent inclusion. **Express Scripts (NASDAQ: ESRX)** was up some six percent since being added in March**. Foot Locker (NYSE: FL)** was also up slightly to match the performance of the overall market this month.

Our other healthcare picks **AbbVie (NASDAQ: ABBV)** and **Gilead Sciences (NASDAQ: GILD)** were also up mildly since our last update. **JP Morgan (NYSE: JPM)** is up nicely since inclusion in our original five stock portfolio that rolled out in mid-January but the stock did little over past few weeks despite being on the cover on Barron's which cited the shares as 30% undervalued. We need for the economy to improve over anemic first quarter GDP growth levels and interest rates to move north of two percent on the ten year Treasury yield before the next leg up on this financial stock.

Our clear star this month was **Las Vegas Sands (NYSE: LVS)** which was up nearly 10% since our last update. This is despite gambling revenues being down throughout Macau 40% on a monthly year-over-year basis. This could signal that the bottom is in for casino operators on the enclave and comps should improve in the third quarter of 2015.



Apple (NASDAQ: AAPL), which has be a great performer for the portfolio since being one of our inaugural portfolio picks, was down slightly over the past few weeks. The stock seems to be going through a normal consolidation phase after posting big gains in first quarter of the year. **Micron (NYSE: MU)** was also down slightly since our last update which is impressive given PC sales fell more than six percent year-over-year in the first quarter. The company did announce its long awaited 3D NAND product line with partner **Intel (NASDAQ: INTC)** this month.

Rounding out our portfolio, **Valero (NYSE: VLO)** was down slightly for the month despite an "Outperform" rating and $70.00 a share price target from Cowen in late March.

As always, if you have a question about our portfolio holdings or how they fit the strategy just send me an email at bret.jensen@investorsalley.com.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Yield	Returns	S&P 500 Comp.
Qualcomm (QCOM)	04/15/15	$68.46	$68.46	2.9%	N/A	N/A
Capital One (COF)	04/15/15	$82.82	$82.82	1.5%	N/A	N/A
Express Scripts (ESRX)	03/18/15	$83.29	$84.23	-	1.1%	0.3%
Foot Locker (FL)	03/18/15	$61.17	$62.52	1.6%	2.2%	0.3%
AbbVie (ABBV)	02/13/15	$58.05	$57.10	3.5%	-1.6%	0.5%
Valero Energy (VLO)	02/13/15	$58.60	$63.45	2.7%	8.3%	0.5%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$97.72	-	-3.0%	4.3%
Micron Technologies, Inc. (MU)	01/16/15	$28.99	$27.13	-	-6.4%	4.3%
Apple Inc. (AAPL)	01/16/15	$105.99	$124.25	1.5%	17.2%	4.3%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$59.95	2.9%	7.2%	4.3%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$54.97	4.6%	0.1%	4.3%

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: 04/15/15. 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.