Investors Alley

July 2015 Vol. 1 Issue 7

Bret Jensen's Blue Chip Gems

NASDAQ Grinds Higher While DJIA and S&P 500 Tread Water: Our Strategy

Fellow Investor,

It has been an interesting month in the markets since our last update to say the least. Equities were testing the top end of their trading range for most of the past thirty days with the NASDAQ posting all-time highs. The triggers for the rally included optimism around the latest deal around Greece that kicked the can down the road, at least until 2016. The market was also buoyed as it appeared the Chinese authorities managed to arrest the steep decline within their equity markets.

In This Issue

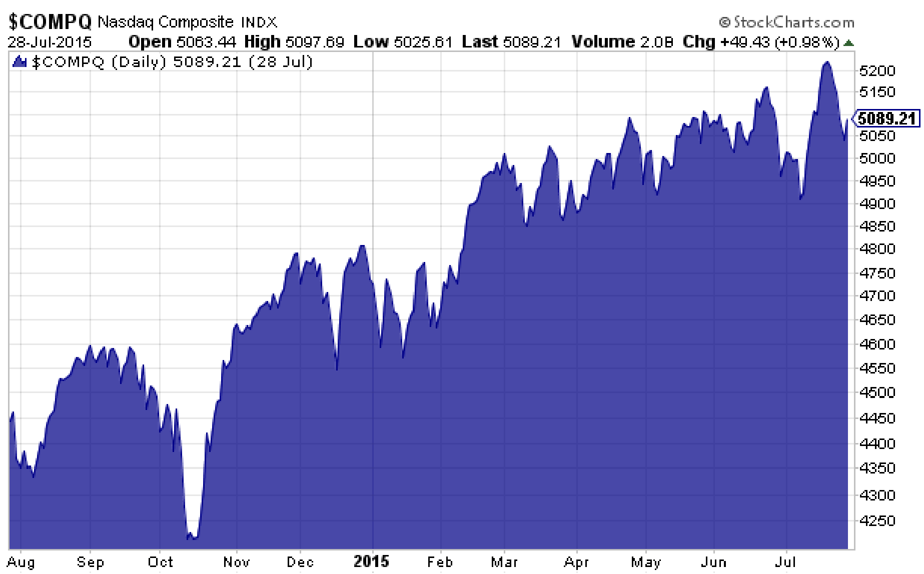
Bank of America (BAC) 3

Portfolio Update 5

Current Portfolio Standings 6

However, those gains started to evaporate last week as the Dow gave up some 600 points from its highs on Monday as investors started to factor in the first half of the year is providing no year-over-year earnings or revenue growth in the first half of the year. The commodity complex is just downright ugly as global mining stocks are in freefall and the energy sector has posted 12 straight weeks of decline. The S&P 500 after this gyration is pretty much exactly where it was a month ago.

One of the worrying signs of the market recently is how much breadth has been narrowing as stocks have continued to grind up. All of the NASDAQ's rise this year is due to the five largest stocks in the index, of which only **Apple (NASDAQ: AAPL)** sports an attractive valuation. The rest seem to be in nosebleed territory such as **Netflix (NASDAQ: NFLX)** which is going for more than 200 times next year's profit projections.



The market is being primarily driven by momentum right now. It is hard to get my mind around how investors can bid up **Amazon (NASDAQ: AMZN)** more than 15% on the day it reported a surprise profit of $92 million for the quarter and surpassed the market capitalization of giant **retailer Walmart (NYSE: WMT)** which posted earnings of over $3 billion in its last completed quarter. Meanwhile Apple reports an almost 40% increase in year-over-year earnings to some $11 billion and the stock sells off on the results.

Although it is getting harder to find relative bargains in what I consider an overbought market, I believe investors should have a good slug of their portfolios in large cap growth positions selling at reasonable or attractive valuations. If/when a correction comes to the market these names should hold up much better than the market as a whole. I expect the momentum names that have driven a good portion of the gains in the market in 2015 to take the brunt of the pain when a pullback in equities does occur.

Until then we will continue to build the Blue Chip Gems portfolio slowly and prudently as I believe there is a good chance we will have some lower entry points in the months ahead.

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

Bank of America

This month we are increasing our exposure to the financial sector. We are doing this as it is one of the few areas of the market where I am still seeing some value. We are adding a major bank to our portfolio as the secular tailwinds for this sector of the financial industry are changing for the better which I will detail in the analysis below.

Banks have hardly been considered "Blue Chip Gem" material since right before the financial crisis. They have been more "turnaround" fodder for more than half a dozen years now. However, for decades before the crisis they were look on as stable investments that provided consistently decent growth along with generous dividend yields.

Now that we are coming to the end of the current administration, the litigation gauntlet banks have endured over the past five years is ebbing. In addition, interest rates should rise over the next few years and major financial institutions should be buoyed by a healing domestic economy and a reviving housing market. We have done well with our selection of **JPMorgan Chase (NYSE: JPM)** since this bank was added to the Blue Chip Gems portfolio early in 2015. This month we are selected its brethren **Bank of America (NYSE: BAC)** to join it within the portfolio.

There are some specific reasons why we are adding Bank of America which are detailed at the bottom of the analysis. First, let's look at the tailwinds that should benefit all major banks over the coming quarters and years.

Rising Interest Rates:

This is a critical trend that should play out over the coming years as the Federal Reserve "normalizes" monetary policy. This will help net interest margins, one of the biggest profit drivers at banks. Just a 50 basis point increase means billions and billions of extra annual earnings for all the major banks. This trend has just started as yields have gone up significantly since the first quarter of this year. With the Federal Reserve set to hike interest rates for the first time since 2006 by year end and domestic GDP growth accelerating from a tepid first quarter interest rates should continue to rise gradually over the next few years barring a recession.

Legal costs dropping:

One of the substantially positive things that came out of this quarter's earnings reports at major banks is that legal costs are finally starting to drop across the board. It seems the legal gauntlet banks have endured over the past half-decade is at long last starting to ebb. It is about time as well. Major banks have paid more in fines and settlements than they actually posted in credit losses from the financial crisis and its immediate aftermath.

This has affected the economy and is one reason we have seen two percent GDP growth throughout what is the weakest post war recovery on record. To put in perspective, the average of the previous nine post war recoveries is roughly twice this metric. One key factor to this slow growth is that banks have curtailed loan growth due to new regulations and the need to focus on the legal aftermath of the financial crisis.

Now that a "pound of flesh" has been extracted, banks should be able to focus more on prudently growing their loan book. This will be good for earnings growth and the economy overall. As importantly, the huge legal costs banks have booked regularly over the past few years will drop considerably in the coming quarters and years. This will be a huge boost to the bottom line at these financial institutions.

A Recovering Housing Market:

One of themes that is staring to play out in the economy is that housing activity is starting to accelerate at a significant clip. Home builder confidence is at a ten year high and housing starts are increasing at a solid pace. After being deeply under the annual average of the past three decades since 2007, housing starts are finally to tick up but have quite a way to go before they get back to long term trend levels. With household formation increasing nicely and mortgage credit finally starting to loosen housing activity should increase at a solid pace for years to come. This increased activity is already starting to show up in the improve results in the quarterly earnings reports at myriad homebuilders. This accelerating housing market will provide an important earnings driver to major banks as their mortgage origination activity and loan book will benefit by higher home sales and starts.

Minuscule Default Rates:

Loan loss ratios at **Wells Fargo (NYSE: WFC)** are at their lowest levels in at least two decades and at JP Morgan they are at lows not seen since the late 1990s as this development is playing out at all the major banks. With the strongest job growth in a decade and with wages just starting to accelerate, this trend should continue. Obviously this will be a continuing tailwind to earnings growth.

Why Bank of America?

Bank of America and **Citigroup (NYSE: C)** have been the most challenged of the major banks throughout the recovery. One of the key reasons I like B of A over Citi is it does not have the international exposure that Citi does, especially in emerging markets that are particularly troubled right now. A strong U.S. dollar is not cutting into Bank of America's earnings outlook as well.

In addition, Bank of America should have the fastest earnings growth of any of the major banks over the next couple of years. After posting earnings of just 36 cents a share in FY2014, the bank is on track to post profits of approximately $1.40 a share this fiscal year. Next year, that number should come in within the range of $1.50 to $1.80 a share depending partly on how well the domestic economy grows in 2016. This puts the stock with a valuation of 10 times the top end of next year's earnings range. This is cheap in a market that goes for roughly 17 times forward earnings.

In addition, based on book value Bank of America is undervalued compared to its brethren. It sells at roughly a 30% discount on book value to JPMorgan Chase, Wells Fargo sells for roughly twice the book value as B of A as well. Bank of America has a dividend yield of just 1.1%, lower than the other banks. However, it also has a minuscule payout ratio of approximately 15% of this year's earnings. That payout ratio should increase towards 40% to 50% in coming years as regulators are satisfied banks are meeting their new capital ratios and grant approvals for more of banks' earnings to go to dividend increases and stock buybacks.

Finally, Bank of America is diligently targeting operational costs. The bank is seeing a surge in mobile banking which is allowing the bank to slowly cut branch and employee costs. I bought Bank of America just over $5.00 a share near the lows of the financial crisis. I have benefitted from company's turnaround story as the shares now go for just under $18.00 a share. The bank still has plenty of room to rise to get anywhere near previous highs of the last decade. Its Merrill Lynch business might eventually be spun out to create additional shareholder value, but I do not see that happening for the next year or two; it is a valuable asset that bears noting.

The earlier turnaround play on Bank of America notwithstanding, with myriad positive tailwinds for banks in place it is time to move Bank of America firmly into the large cap growth stock selling at a discount to the overall market as well as to its banking brethren. In short, just the type of long term value we try to uncover here at Blue Chip Gems.

Recommendation: Buy BAC up to $20.00 a share

Position: Long BAC

Portfolio Update

As covered in the beginning of this month's issue, the market has started to get quite choppy as we get into the meat of second quarter earnings season. I believe the rest of the summer will continue to see increased volatility as the combination of negligible earning growth, a plunging commodity and energy complex, a strong dollar, the stock market plunge and the unfolding situation in Greece continue to roil equities.

As one might expect in this topsy turvy environment, the performance of the Blue Chip Gems portfolio was a mixed bag this past month. Let's start with the challenges within the portfolio at the moment. Technology stocks, especially those of chip makers, have had a rough ride as the decline in PC sales has been much worse than analysts were predicting at beginning of the year and server sales have not been robust either.

Both **Micron (NYSE:MU)** and **Qualcomm (NASDAQ: QCOM)** have been poor performers. Micron has received a buyout offer of $21.00 a share from giant Chinese player. I doubt the company will accept this lowball offer and doubt it could past regulatory muster in any case. This offer should put a floor under the stock and we will hold to see if business picks up as we head to the seasonally strong fourth quarter. Qualcomm is starting to listen to analysts and may initiate a break up of their company into two businesses which should unlock shareholder value.

Capital One (NYSE: COF) had a disappointing earnings report this quarter, missing on both the top and the bottom line as competition in the auto loan market heats up. The shares are slightly under our entry point after giving up recent gains due to its quarterly results. The stock is cheap at 10 times next year's earnings consensus and we hope for stronger performance in the quarters ahead. **Blackstone (NYSE: BX)** also delivered a tepid quarterly report but is cheap at 10 times forward earnings with a very large dividend yield.

On the brighter side, **Las Vegas Sands (NYSE: LVS**) has performed better since its quarterly results provided some confirmation that the worst in Macau is almost at an end. We also continue to get strong performance from the health care names in the portfolio**. Celgene (NASDAQ: CELG)** was a standout performer this month and delivered strong gains as investors applaud its $7.2 billion purchase of **Receptos (NASDAQ: RCPT)** as well as its collaboration deal with immunotherapy concern **Juno Therapeutics (NASDAQ: JUNO)**

Refiner **Valero Energy (NYSE: VLO)** performed strongly this month. The refining sector is about the only part of the energy complex that is showing any strength as crude oil continues to plunge and domestic natural gas prices remain low. Valero is best of breed in the refining space and probably the only energy holding we carry until the direction of energy prices gets clearer.

We will continue to build our portfolio slowly. Equities feel like they are at an inflection point, and I do not believe we will see strong performance in the overall market until at least until the close of summer.

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.
Bank of America (BAC)	07/28/15	$17.88	$17.88	1.1%	N/A	N/A
Celgene Corp. (CELG)	06/26/15	$117.92	$135.42	-	14.8%	4.1%
Blackstone Group (BX)	05/18/15	$43.64	$38.61	7.7%	-11.5%	-0.6%
Qualcomm (QCOM)	04/15/15	$68.46	$63.10	3.1%	-7.8%	-0.6%
Capital One (COF)	04/15/15	$82.82	$78.65	2.0%	-5.0%	-0.6%
Express Scripts (ESRX)	03/18/15	$83.29	$92.38	-	10.9%	-0.3%
Foot Locker (FL)	03/18/15	$61.17	$69.01	1.4%	12.8%	-0.3%
AbbVie (ABBV)	02/13/15	$58.05	$71.23	3.1%	22.7%	-0.2%
Valero Energy (VLO)	02/13/15	$58.60	$65.07	3.0%	11.0%	-0.2%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$113.07	1.4%	12.3%	3.7%
Micron Technologies, Inc. (MU)	01/16/15	$28.99	$19.75	-	-31.9%	3.7%
Apple Inc. (AAPL)	01/16/15	$105.99	$123.38	1.7%	16.4%	3.7%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$68.05	2.6%	21.7%	3.7%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$54.14	4.7%	-1.4%	3.7%

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: 07/28/15. 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.