Investors Alley
October 2015 Vol. 1 Issue 10
Bret Jensen's Blue Chip Gems

Not All Stocks Are Created Equal in This Market

In This Issue

Fellow Investor,

The major indices have had a much better October after a very challenging August and September. The market overall is pretty flat for the year. The recent rally has been achieved on narrowing breadth and amid myriad worrying signs. This reinforces my position on just how important it is to have a portfolio of stocks that can grow earnings and revenue even during these challenging economic times.

Investors seem to be reacting to the actions of central banks more than fundamentals at the moment. The Federal Reserve passed on raising rates at their September meeting and they look like they will punt on raising rates for the first time since 2006 until at least early 2016 now. Global equities were also buoyed by recent comments from the European Central Bank stating that they were ready to “do more” if necessary. The central bank of China also cut interest rates once again as its economy continues to decelerate.

As of last week, with a third of the S&P 500 companies reporting quarterly earnings, profits are down almost three percent year-over-year. Revenues are down roughly four percent as the strong dollar continues to have its impact especially on large American multinationals. This quarter will likely be the first quarter since the third quarter of 2009 that both profits and sales have fallen in the same three month period. It is also the third quarter in a row that revenues have fallen from the same period a year ago. Five of the ten sectors of the market are expected to deliver earnings declines this quarter, led of course, by the collapse of profits in the energy sector.

Given this backdrop I think the consensus calling for overall earnings growth in 2016 at or near 10% is much too optimistic and will have to come down significantly in the months ahead. With the market going for more than 16 times those forward earnings, equities still appear overvalued right here to me.

In addition, after clocking in almost four percent GDP growth in the second quarter; the economy has definitely weakened so far in the second half of the year. New home sales just came in weaker than expected for September. This month’s Durable Goods report was very weak with the prior month’s numbers being revised down significantly.

Global growth looks like it will show the weakest demand levels since 2009 when 2015 is put to bed. In the current market environment one wants to hold companies that can still churn out earnings and revenue growth despite a very challenging worldwide backdrop. One also wants to own firms that have solid balance sheets, produce significant free cash flow, are attractively valued and can reward their shareholders with dividends and stock buybacks.

It is these concerns we continue to aim to find and profile. This month we add another name to the portfolio that has all of these desirable traits.

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

Merck: High Dividend Yield and Brighter Days Ahead

We have a fairly high exposure to healthcare in the Blue Chip Gems portfolio. That exposure consists primarily of biotech stocks like **Gilead Sciences (NASDAQ: GILD), Amgen (NASDAQ: AMGN)** and other similar concerns as well as an investment in the largest pharmacy benefit management (PBM) in the world in **Express Scripts (NASDAQ: ESRX)**.

There is a logical reason for this overweighting. Simply put, despite a large sell-off in the biotech and pharma sectors in the August to September period, the sector is one of the few that is showing good earnings and revenue growth in what is an increasingly challenging global backdrop. Healthcare should once again show the best year-over-year earnings growth out of the 10 industry groups in the S&P 500 when the book on third quarter earnings is closed. Five of the ten sectors should post negative earnings growth this quarter which is a strong sign showing how difficult the macro environment has become over the past year.

This exposure served us well in October as we saw nice rallies across the healthcare names within our portfolio this month. This is why we are going to add a pharma concern to our portfolio to provide further diversification to our healthcare holdings and also to add some additional yield to our positions. There are several good names to look at right now**. Pfizer (NYSE: PFE)** and **Bristol Meyers Squibb (NYSE: BMY)** reported earnings Tuesday that beat expectations and both companies raised guidance as well.

However, we are going to select another large and well-known pharma name that also reported better than expected earnings and raised guidance the same day.

Company Overview:

Merck (NYSE: MRK) operates as the global healthcare leader, with operations in some 140 countries. The company has been around for more than 100 years and the stock has a market capitalization of just north of $150 billion and employs some 70,000 people worldwide. The company has a diversified portfolio of products in the areas of prescription medicines, vaccines, biological therapies, and animal health products. It has a deep pipeline of new products across these areas as well.

Recent Events:

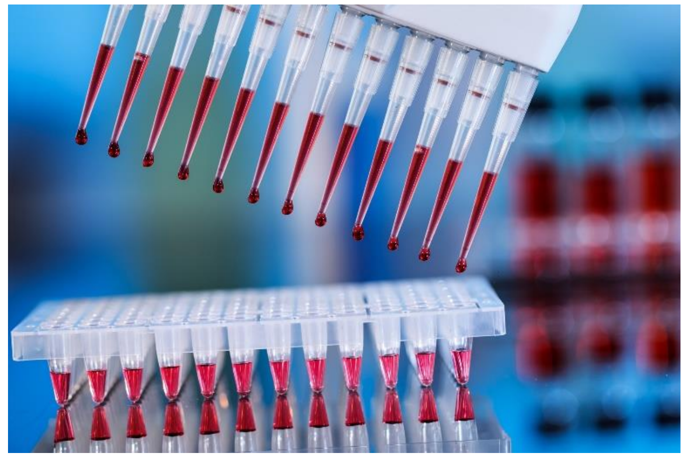
This week the company posted third quarter earnings of 0.96 cents a share, 4 cents a share above the consensus. Revenue was down 4.6% year-over-year but in line with expectations. Management upped the low end of their range for full year revenue by just over a billion dollars to $39.2 billion. The company's full year earnings per share guidance moved up a dime a share to $3.55 to $3.60 a share for FY2015.

The main reason revenues were down from the year ago period was that biologic Remicade recently came off patent and is now subject to competition from biosimilars. Quarterly sales fell to $442 million in the quarter which was off 26% from the same period a year ago. Remicade belongs to the class of biological response modifiers called tumor necrosis factor (TNF) blockers. It is important to remember that biologics are harder to copy and when patents expired, so sales do not fall off a cliff like small molecule based blockbusters like Lipitor. Merck is seeing current patients stick with its regiment while losing new patients to biosimilars. So although sales will continue to fall, this compound will continue to be a cash cow for the foreseeable future.

On a brighter, sales of Januvia were up nearly nine percent on the year and crossed over $1 billion in annual sales this quarter. Januvia is an enzyme-inhibiting drug used as a treatment for diabetes, a disease that continues to increase worldwide as demographics are aging and obesity rates continue to rise.

The standout of the quarter were the ten-fold sales increase seen in the quarter year-over-year for Merck's new compound "Keytruda" which is a human antibody used in the emerging area of immune -therapy. This new space is predicted to have overall revenues north of $35 billion annually by 2025.

Keytruda sales came in over $350 million this quarter and this compound has a significant growth trajectory as it rolls out and is approved for additional indications of various forms of cancer. The compound received FDA Fast Track designation in late 2014. Earlier this month, the FDA approved Keytruda for the most common form of lung cancer whose tumors produce a specific biological marker. The product is also being paired with compounds from three major industry players in trials to expand its reach/markets.



Key Pipeline Products:

In addition to being excited about the growth path of recently approved Keytruda, investors should also be hopeful for Merck's new hepatitis C offerings which should be out in the first quarter of 2016. An analyst at Citi recently commented that the company should see between $600 million to $700 million in sales from these products in 2016. That could turn out to be on the low side given the recent FDA labeling of the adverse effects of the Viekera Pak which is currently the second largest hepatitis C treatment on the market and the huge market (over $20 billion annually) right now for hepatitis C cures. The current consensus has this hepatitis C combination pill of grazoprevir and elbasvir to bring in slightly more than $3 billion in annual sales by 2020.

The company has late stage trials going on currently for compounds to treat Alzheimer's as well a new type of cholesterol drug outside the new PSCK9 inhibitor family. Given the challenges other major pharma firms have recently encountered in both areas, I put a low probability for success on either effort at this point in time. They should be noted only because if I am wrong the value of Merck's pipeline increases significantly.

Balance Sheet & Dividend Yield:

The company has done a series a very incremental dividend raises over the past few years as it has dealt with declining revenues and cutting operational costs. I like the commitment of the firm to provide even token dividend hikes in difficult times. It bodes well for accelerating payouts as growth returns to sales starting in 2016. Currently the dividend yield is a solid 3.3+% on an annual basis. In addition, the company has a rock solid balance sheet and substantial financial flexibility. In addition, the company's return on equity is slightly north of 20% which is very solid in the current market.

Summary & Outlook:

Merck has spent most of last five years rebuilding its pipeline and dealing with key patent expirations. Sales have fallen over that period even as earnings have been on the increase thanks to cost cuts and rationalization of the organization. Merck's pipeline and new products should finally result in a low mid-digit sales increase in FY2016 as growth returns to the company.

This should result in mid-single digit earnings growth next year and hopefully a bit faster growth in the years ahead if Keytruda and/or its coming hepatitis C treatments show good growth. The stock sells for 14.5 forward earnings, a discount to the 16.5 times the overall market goes for at current levels. Combine this with its over 3% dividend yield; the stock is a solid combination of value, growth and yield. Finally, should the global economy continue to be rocky; Merck is a good defensive play for challenging economic times.

Recommendation: Buy MRK up to $57.50 a share.

Position: Long MRK

Portfolio Update

As I mentioned in this month's Market Commentary, the market has rallied despite the fact of falling year-over-year earnings and revenues. The rally has occurred with narrow breadth and 2015 has been the hardest on investors that we have seen in many years. More than one large hedge fund has closed up shop this year as trying to figure out the market when myriad central banks can intervene at any time has been an exercise in futility.

The good news is that most of the recent rise has occurred in the quality large cap growth names this newsletter focuses on identifying. Just about every stock in the portfolio has had nice up moves since our last update with the exception of **Foot Locker (NYSE: FL)**. The footwear retailer seems to be hit unfairly by poor results at **Skechers (NYSE: SKX).** I added a few shares on its recent drop and think the company will report solid number when it delivers quarterly numbers in late November.

Las Vegas Sands (NYSE: LVS) is up more than 15% from our last update. Recent comments from Macau's regional authority about bolstering growth as well as another interest rate cut by China's central bank has improved sentiment on the name. The over five percent dividend in this low yield environment is also helpful.

Our financial holdings of **JP Morgan (NYSE: JPM)**, **Blackstone (NYSE: BX), Capital One (NYSE: COF)** and **Bank of America (NYSE: BAC)** are all up since our last update. These companies delivered solid but not spectacular quarterly results. If we ever get a rate hike and the prospect of higher interest rates, we could finally see this sector start to outperform.

Our big winners came from the healthcare sector despite all the negative focus during the month on drug giant **Valeant Pharmaceuticals (NYSE: VRX)**. We saw major gains from our holdings of **Amgen (NASDAQ: AMGN)** and **Allergan (NYSE: AGN).** This makes sense as despite negative headlines, the healthcare sector is delivering the best year-over-year earnings growth of any of the 10 industry sectors in the S&P 500.

Finally, both **Gilead Sciences (NASDAQ: GILD)** and **Apple (NASDAQ: AAPL)** reported after the bell on Tuesday. Both companies easily beat on the top and bottom line consensus. Both stocks are up since our last update but continue to not get the respect their growth deserves in the market place and are cheap on a valuation basis.

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.
Merck (MRK)	10/27/15	$53.47	$53.47	3.3%	N/A	0.0%
Allergan (AGN)	09/29/15	$254.87	$263.42	-	3.4%	10.9%
Amgen (AMGN)	08/28/15	$155.89	$150.45	2.1%	-3.5%	5.1%
Bank of America (BAC)	07/28/15	$17.88	$16.20	1.3%	-9.4%	-0.1%
Celgene Corp. (CELG)	06/26/15	$117.92	$116.24	-	-1.4%	-0.5%
Blackstone Group (BX)	05/18/15	$43.64	$33.36	8.7%	-23.6%	-1.8%
Qualcomm (QCOM)	04/15/15	$68.46	$59.00	3.5%	-13.8%	-0.8%
Capital One (COF)	04/15/15	$82.82	$74.58	2.1%	-9.9%	-0.8%
Express Scripts (ESRX)	03/18/15	$83.29	$87.09	-	4.6%	-0.4%
Foot Locker (FL)	03/18/15	$61.17	$69.76	1.4%	14.0%	-0.4%
AbbVie (ABBV)	02/13/15	$58.05	$54.83	3.4%	-5.5%	-0.3%
Valero Energy (VLO)	02/13/15	$58.60	$60.08	2.5%	2.5%	-0.3%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$101.66	1.6%	0.9%	3.5%
Micron Technologies, Inc. (MU)	01/16/15	$28.99	$17.09	-	-41.0%	3.5%
Apple Inc. (AAPL)	01/16/15	$105.99	$113.77	1.8%	7.3%	3.5%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$62.52	2.8%	11.8%	3.5%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$47.32	5.6%	-13.8%	3.5%

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: 10/27/15. 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.