Investors Alley
Bret Jensen's Blue Chip Gems
November 2015 Vol. 1 Issue 11

Looking Ahead to What the New Year Will Offer

Fellow Investor,

Equities continue their recent roller coaster ride albeit within a fairly narrow overall trading range. Last week the S&P 500 posted its best weekly performance since December of 2014. This basically brought the index back to even from the week before, which was one of the worst weeks for investors in 2015.

There is a lot of bad news in the markets right now, but one thing I would like to stress is that the Blue Chip Gems portfolio is made up of selections that will be able to grow revenue and earnings even in this market. I believe it is more important now than ever in the last six years to have a portfolio of these stocks that will be able to grow and prosper regardless of outlying economic factors.

In This Issue

The major indices have managed to post slight gains for the year as we head into the homestretch of 2015. This is quite the accomplishment given profits for the S&P 500 are heading to their first year-over-year decline since 2009 and global growth levels are at their weakest levels in a half dozen years as well.

In addition, most of the gains have been concentrated in an extremely thin slice of large cap concerns, most of which sell at very high multiples like **Amazon (NASDAQ: AMZN)** and **Netflix (NASDAQ: NFLX)**. Investors who did not have a good slug of those names in their portfolio are seeing red ink in their brokerage and 401K statements.

Third quarter earnings season is now largely over, and, not surprisingly, most companies stepped over pessimistic expectations even as year-over-year profits for the S&P 500 fell for the second quarter in a row. It looks like we will see that trend continue in the fourth quarter as well. More than two thirds of the companies reporting managed to "beat" their earnings consensus. Tellingly, less than half exceeded revenue expectations as the strong dollar and tepid global demand continue to take their toll.

In global news, this month has seen an escalation in strife with the heinous and cowardly acts in Paris leading a list of activity that fell on many countries over the past month. Syria continues to descend into civil war causing the biggest migration of people since the end of World War II and causing considerable political and economic distress for the European continent.

Energy and commodity prices continue to hover at multi-year lows as demand in China is just not what it has been in recent years; this is causing stress for commodity based emerging markets like Brazil, Argentina, and Russia. Closer to home, the collapse in crude oil prices has cause a measureable slowdown in the economies of Canada and Mexico, two of our largest trading partners.

Domestically, we continue to muddle along with two percent GDP growth which has been the standard throughout the weakest post war recovery on record even as the bull market is now the third longest on record. Weird times indeed.

I wish I could say I see a sharp acceleration in global growth on the horizon, but my view is more along the lines of “Crampus” than jolly old Saint Nick on the worldwide economy at the moment as we approach the holidays.

Closing on a brighter note, the environment should continue to reward those large cap growth concerns that make up the vast majority of the Blue Chip Gems portfolio that can continue to churn out both revenue and earnings growth in a very difficult global environment. They should continue to do well even in a flat equity market which is my current outlook for 2016 at the moment.

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

Macy's: Little Downside With Big Opportunity

Our next addition to the Blue Chip Gems portfolio is widely acknowledged as the best run department store chain in the market. The shares have had a recent blip that have took the stock from over $70.00 a share to under $40.00 a share, which is more than excessive. The trigger for the decline was a third quarter miss combined with weak guidance. The retailer is being hit at the moment with tepid consumer spending despite low gasoline prices as well as a slowdown from foreign visitors as a result of a strong dollar and tepid overseas growth.

These factors are likely to turn out to be temporary and start to fade over the next 6-12 months. I see little risk to the downside here given the value of the company's real estate holdings and their high dividend yield. Shareholders should benefit greatly as consumer demand eventually returns and the stock is lifted from its current dirt cheap valuation on an earnings basis.

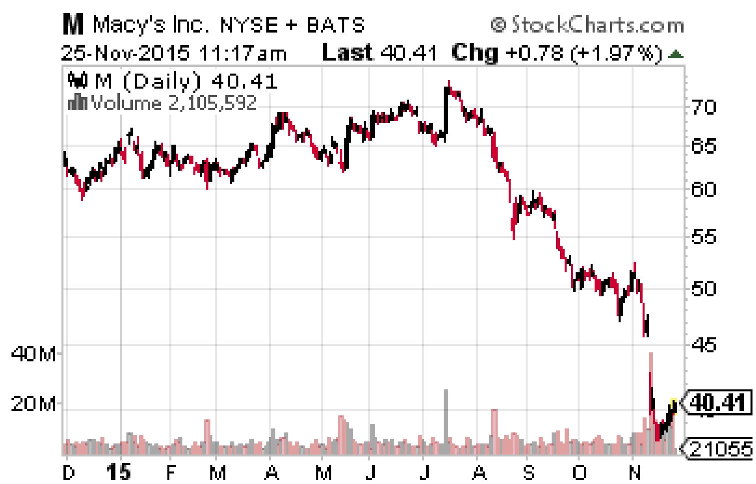
Company Overview:

Macy's (NYSE: M) operates some 900 stores in 45 states, the District of Columbia, Guam and Puerto Rico under the names of Macy's, Bloomingdale's, Bloomingdale's Outlet, Macy's Backstage, Bluemercury, and their related websites. The company has more than 150,000 employees and has a market capitalization of approximately $12.5 billion.

The company has been around since 1858 and is still recognized as one of the most powerful retail brands. It also has a growing online presence and is probably the best in the industry of melding the two channels. It also runs its own credit card operation.

Two Floors:

One of the main reasons I like the stock at these levels is it hard to see much downside outside a recession for the shares given two factors.



Real Estate:

The company owns the vast majority of real estate its locations occupy. This includes its iconic Herald Square location in New York which sits on an entire city block and where the famous Macy's Thanksgiving Day Parade runs by. This location alone is worth several billion dollars given the value of land in the Big Apple. Starboard Value put a valuation on this one holding at $4 billion, more than 30% of the company's current market capitalization. Including debt this one location would be worth 20% of Macy's enterprise value.

More than one activist fund has pushed Macy's to convert its valuable real estate holdings into a real estate investment trust (REIT) to unlock shareholder value. The numbers funds have thrown out there indicate Macy's real estate holdings are worth $40.00 to $60.00 a share spun off in this structure. Even if they are worth half of those projections, a good portion of the company's recent stock price is represented just by Macy's properties which does not even touch on its brand value or what its operations are worth. The company, is after all, churning out earnings and is not a version of downtrodden Sears.

The company has looked at a REIT structure but has passed for the current time as it does not want to give up the financial flexibility it enjoys under the current asset structure. It may work with brokers to rent out some of its underutilized space, but for the moment will not pursue a grander strategy.

Dividend:

The other big floor under the stock at current levels is its robust dividend yield. Macy's yields over 3.7% at its current price of approximately $40.00 a share. That is in line with a lot of so called "income" sectors of the market like Utilities. Macy's can be had for a much lower valuation and has better prospects for longer term growth. Since emerging from the financial crisis in 2009 the company has more than sextupled its dividend payout from a nickel a share to 36 cents a share. It has done this with frequent raises to payout including earlier this year when it raised its dividend by a little less than a nickel a share. The company has a conservative payout ratio of approximately 35%, and combined with earnings growth this dividend trajectory should continue albeit at a slightly lesser pace.

Valuation:

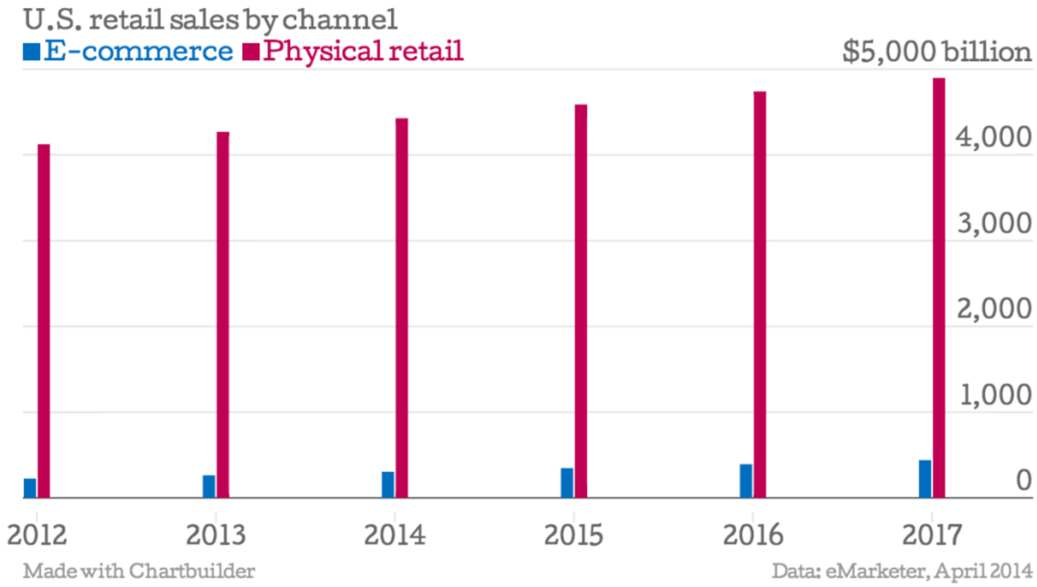
Earnings are going to be slightly down this year and probably flat next year unless the dollar weakens and/or foreign visitor traffic picks up significantly in the year ahead. I don't see either happening currently but eventually things usually return to the underlying trend. Until recently, Macy's was a huge benefactor from overseas traffic.

After its recent decline the stock is going for just nine times the $4.40 a share the company made in FY2015. Over the past five years, the stock has traded with a trailing PE ratio of 14.4 times earnings. If we put a conservative earnings multiple of 12 times the $4.20 to $4.30 a share the company just guided profits to in FY2015, Macy's should be trading at over $50.00 a share. This would give it just two thirds of the current overall market multiple and seems more than warranted given its large dividend yield and the current challenges in retail. A return to its previous valuation multiple would fetch more than $60.00 a share based on current earnings.

Outlook:

Every retailer has to worry about being "Amazoned" with few exceptions. However, it is important to keep in mind that over 90% of U.S retail sales still come from physical stores. In other words, less than 10% of sales currently happen on the internet. Internet sales are still growing faster than those from physical stores but that growth is slowing and is currently in the low teens.

It is very important for department stores and other retailers to provide different ways for consumers who like their brand to purchase items. This is why Macy's has spent so much focus on its e-commerce efforts and even **Amazon (NASDAQ: AMZN)** is rumored to be thinking about opening a physical location in New York City.



The company's president recently stated around its e-commerce channel "Macy's is already one of the largest and fastest-growing digital platforms in the country. Our fast-growing digital offering, including robust apps and mobile-enhanced websites, integrate with our stores to provide an unparalleled omnichannel shopping experience for customers... as a result, we are able to attract new customers and grow sales profitability."

Macy's is not sitting on its laurels. The company recently announced plans to close 35-40 underperforming stores which together represent about 1% of the company's total sales over the next few years. This should help reduce operating costs by some $500 million by 2018. Macy's is also experimenting with "the store within a store" concept to boost foot traffic. It will set up ten Best Buy operations within specific Macy's locations and it looks like 500 LensCrafter stores will soon be in over half of Macy's current retail locations as well as the company just signed a deal to integrate these stores within its operational footprint.

The company already has 16 of its own branded Bluemercury cosmetic stores within it larger retail operations. These take 1,000 to 1,500 square feet within the store and have high sales per square foot. The company plans to open another 40 of these concept "stores within a store" locations over the next two years. It acquired Bluemercury for just over $200 million in the first quarter of this year.

Summary:

It is harder to get more "Blue Chip" than a retailer with a well-known brand name that has been around for more than a century and a half, and the company has certainly navigated much more dire circumstances than it currently faces. Macy's has also taken actions to reduce operational costs, boost sales and return to its previous growth trajectory. While we await for management to turn around its undervalued assets, we get to collect an almost four percent dividend yield while waiting for the market to properly value Macy's holdings.

Recommendation: Buy M up to $42.50 a share.

Position: Long M

Portfolio Update

The markets have provided plenty of gyrations since our last update, but equities are pretty much smack dab at the same level they were in last month's Blue Chip Gems edition. Companies are providing little in the way of earnings or revenue growth at the moment as it looks like 2015 will be the first time since the world was emerging from global recession in 2009 that profits from the S&P 500 will decline year-over-year.

Obviously the complete collapse of energy and commodity prices over the past 18 months have played an outsized role in that decline. However, even stripping out the energy sector, growth is nothing to write home about with earnings advancing at a mid-single rate on less than a two percent gain in revenues. A good portion of those anemic earnings gains were powered by stock buybacks which stand at record levels.

The big mover in the portfolio this month was **Allergan (NYSE: AGN)** which has announced it will attempt a merger with **Pfizer (NYSE: PFE)** to create the biggest drug maker by sales in the world. **Qualcomm (NASDAQ: QCOM)** had a tough month as it significantly reduced guidance and is navigating a very difficult worldwide chip market environment right now. The same headwinds are hitting **Micron Technologies (NYSE: MU)**, albeit in a different part of the chip space. Qualcomm seems to have found a floor and yields nearly four percent at these levels.

Our financial holdings continue to muddle along while we collect dividends. Our banks should do much better as the Federal Reserve finally starts to lift rates for the first time since 2006 as it will improve their net interest margins. They should also do better from a regulatory point of view when a new administration is elected less than a year from now.

Foot Locker (NYSE: FL) had a rough start to the month as most retail stocks were hit hard on the back of a poor back to school season as well as tepid consumer spending. The widely hailed gasoline "tax cut" most economic pundits were touting at the beginning of 2015 has largely been a dud outside increased restaurant sales. Consumers have largely banked these savings or used them to handle significant rent increases and big health care premium hikes. Foot Locker did have a nice little surge late in the month after its third quarter earnings report beat the top and bottom line consensus.

This month we add a retailer that is widely acknowledged as the best run department store in the country, **Macy's (NYSE:M).** The stock has fallen on some temporary hard times after it reduced guidance due to a fall in foreign visitors and tepid consumer demand. However, the shares are dirt cheap, pay an almost four percent yield, and significantly undervalue its real estate holdings. The company and stock should see brighter days in 2016.

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.
Macy's (M)	11/24/15	$39.63	$39.63	3.7%	N/A	N/A
Merck (MRK)	10/27/15	$53.47	$53.48	3.3%	0.0%	1.1%
Allergan (AGN)	09/29/15	$254.87	$311.43	-	22.2%	10.9%
Amgen (AMGN)	08/28/15	$155.89	$162.78	2.0%	4.4%	5.0%
Bank of America (BAC)	07/28/15	$17.88	$17.47	1.1%	-2.3%	-0.2%
Celgene Corp. (CELG)	06/26/15	$117.92	$112.67	-	-4.5%	-0.6%
Blackstone Group (BX)	05/18/15	$43.64	$30.67	6.3%	-29.7%	-1.9%
Qualcomm (QCOM)	04/15/15	$68.46	$49.41	3.9%	-27.8%	-0.8%
Capital One (COF)	04/15/15	$82.82	$78.63	2.0%	-5.1%	-0.8%
Express Scripts (ESRX)	03/18/15	$83.29	$86.17	-	3.5%	-0.5%
Foot Locker (FL)	03/18/15	$61.17	$65.24	1.5%	6.7%	-0.5%
AbbVie (ABBV)	02/13/15	$58.05	$61.13	3.7%	5.3%	-0.4%
Valero Energy (VLO)	02/13/15	$58.60	$73.03	2.8%	24.6%	-0.4%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$106.57	1.6%	5.8%	3.5%
Micron Technologies, Inc. (MU)	01/16/15	$28.99	$15.63	-	-46.1%	3.5%
Apple Inc. (AAPL)	01/16/15	$105.99	$118.88	1.7%	12.2%	3.5%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$66.78	2.6%	19.4%	3.5%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$44.90	5.8%	-18.2%	3.5%

Recent Price is updated from stock closings on 11/24/15

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: 11/23/15. 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.