Investors Alley

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Bret Jensen's Blue Chip Gems

2016 Will Be the Year of the Value Stock

Fellow Investor,

It is hard to believe we are already coming to a close of another year. The market looks like it will end 2015 pretty much where it started as far as the major averages are concerned. Underneath the surface, 2015 has been a more difficult year for investors than the performance of the major indices would point to. Outside the so called FANG (Facebook, Amazon, Netflix, Google) stocks there have been few areas of outsized performance in the market this year. Unless your portfolio held these positions in size in 2015, it is probably down for the year as almost two thirds of the largest 3,000 stocks by market capitalization are down 15% or more from their yearly highs as we head into year-end.

In This Issue

2015 was also the first year since 2009 that profits within the S&P 500 declined year-over-year. Two primary drivers of the decline were the collapse of the energy and commodity sectors as well as the strong dollar. Global growth looks like it will clock in with just a three percent gain in 2015, which also would be the weakest aggregate demand since 2009.

On a somewhat brighter note, global economic activity is projected to pick up just a tad in 2016. We also just experienced the first interest rate hike from the Federal Reserve since 2006 in December. It was encouraging to see the dollar not spike on the rate hike. Currently the central bank projects it will raise interest rates a total of four times in 2016. However, given the state of both the domestic and global economies I have a hard time seeing more than two interest rate rises in the New Year. In addition, increasing interest rates should be beneficial to the financial sector such as banks and insurers. This is good news for our two positions in **JP Morgan (NYSE: JPM)** and **Bank of America (NYSE: BAC)**.

It is also encouraging to see oil hold onto the $35 a barrel level. This is one of things I am watching closely as we head into 2016. High yield debt in the energy sector is projected to have an 11% default rate in the coming year. If oil falls from here that default level could rise significantly. In addition, commodity based emerging markets like Brazil continue to see their sovereign debt downgraded by rating agencies. This has to be a watch item as we head into the New Year. Any turmoil this causes to the credit markets could easily bleed into the stock market and cause volatility and declines there.

Ending on an optimistic note. Market leadership rarely carries over from one year to the next. Last year, investors bid up anything that could deliver outsized growth, such as **Netflix (NASDAQ: NFLX)**, without regard to extremely stretched valuation metrics. 2016 could well be the year value stock picking comes back into vogue.

That would bode very well for Blue Chip Gems portfolio given the preponderance of stocks within it trading at attractive valuations from companies that have great balance sheets and provide tidy dividend yields. I look forward to the portfolio outperforming the overall market in 2016.

With that, I wish the entire Blue Chip Gems community a happy holiday season as well as a prosperous and healthy New Year.

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. The returns in my other newsletter *Biotech Gems* have been on a tear recently with one position already up 120%. With 19 more recommendations in one of the hottest sectors of the market we are well on our way to building a complete biotech portfolio that should trounce the market for years to come.

In fact, I am giving away three of my favorite tickers in the sector for free right now, just click here.

Alphabet Inc: All the Traits of a True 'Buy and Hold'

We are adding an unusual new selection to the Blue Chip Gems portfolio this month and replacing one technology stock with another. It is unusual only because it is priced at north of 20 times forward earnings and does not yet pay a dividend. In that way it is similar to **Celgene (NASDAQ: CELG)**. However, the long term growth prospects of this tech giant warrant paying a premium to the overall market multiple even after the stock's solid gains in 2015.

The name of the company is **Alphabet (NASDAQ: GOOGL)** which until recently was known formerly by the moniker that has become a verb in our vocabulary, Google. This is one of the notorious FANG stocks whose acronyms have appeared throughout the financial press in 2015. That is because these stocks were some of the few that delivered outsized performance for investors in a year that is rapidly coming to an end.

The stock is that cheapest by valuation of the so called FANG stocks at roughly 22 times forward earnings, which is a tad more than the 20 times forward earnings multiple they started 2015 with. However, the company has done several things in 2015 that merit a higher multiple. In addition, if you take out the huge gobs of net cash that sit on Alphabet's balance sheet, the multiple is really more like 18-19 times forward earnings. This is a slight premium to the overall market which on average does not have this company's long term growth prospects.

I expect this stock to occupy a slot in the Blue Chip Gems portfolio for a long term horizon as it should be able to deliver earnings and revenue increases in the mid-teens for the foreseeable future. It has all the traits, outside a dividend yield, that one should look for in a true "buy and hold" position.

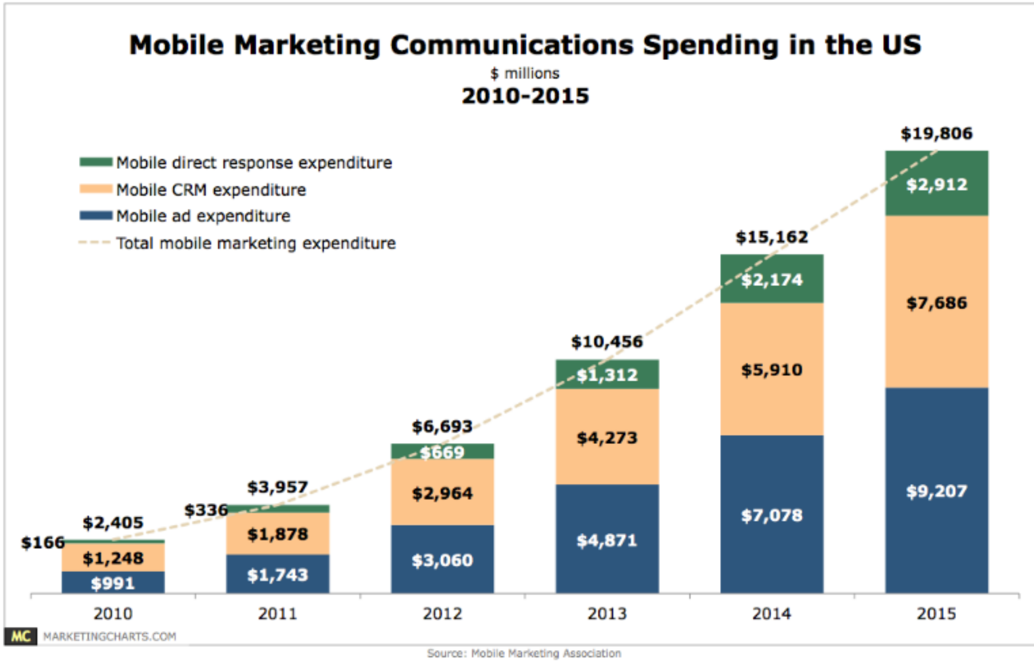
comScore Explicit Core Search Share Report* (Desktop Only)
May 2015 vs. April 2015
Total U.S. – Desktop Home & Work Locations
Source: comScore qSearch

Core Search Entity	Explicit Core Search Share (%)		
	Apr-15	May-15	Point Change
Total Explicit Core Search	*100.0%*	*100.0%*	*N/A*
Google Sites	64.2%	64.1%	-0.1
Microsoft Sites	20.2%	20.3%	0.1
Yahoo Sites	12.7%	12.7%	0.0
Ask Network	1.8%	1.8%	0.0
AOL, Inc.	1.1%	1.2%	0.1

Main Business:

Let's start with the fact that Google outright dominates the domestic search market in both the States, Europe, and many other countries and regions. It has roughly two thirds of the online search market both here and in Europe. It has an even higher (>80%) of the mobile search market in both regions, which of course has drawn the ire of European regulators who have grown frustrated by a lack of a Eurocentric "champion" emerging in this space.

This dominance in the search market and the migration of internet traffic more and more to the mobile medium which Google dominates has led to a dramatic increase in mobile and online ad revenue. **Facebook (NYSE: FB)** and Google are the two heavyweights in these areas and are the beneficiaries of more and more of the overall ad dollar moving from television and radio to online and mobile channels. This is a trend that is firmly established and should continue to play out for the foreseeable future.



As can be seen from the chart above mobile advertising has exploded onto the scene over the past five years. Almost all growth in advertising since the recession ended in 2009 has gone to these two components of digital advertising. The chart below clearly demonstrates that this channel is capturing more and more of the overall advertising dollar. This is a trend that will continue to play out in the years ahead.

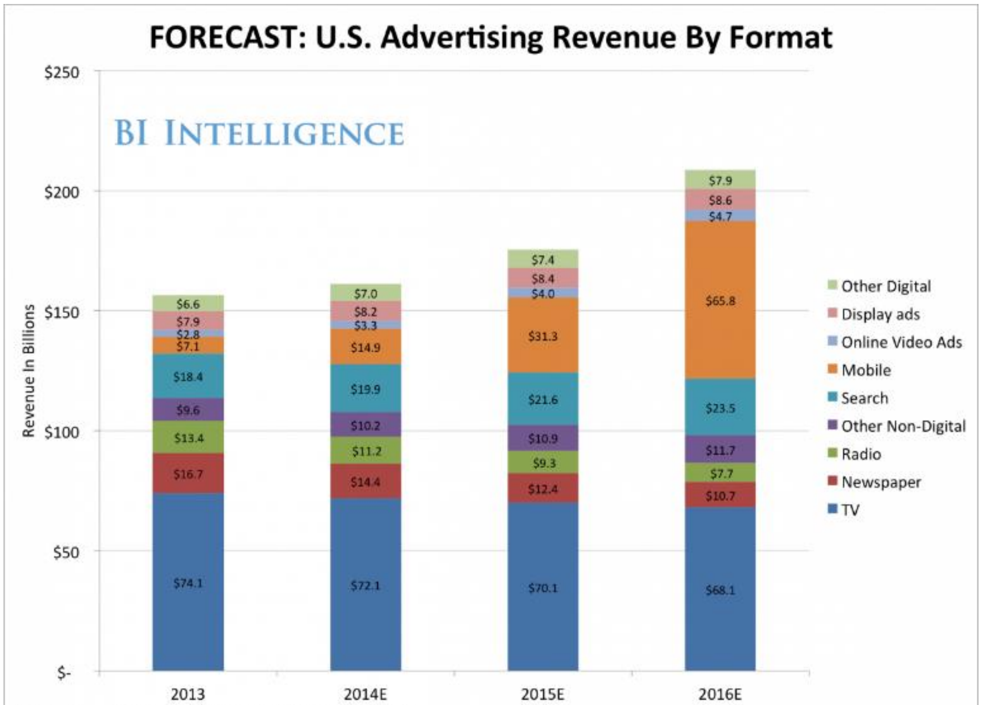
This type of advertising is growing at such a clip because it gives marketers many advantages over traditional TV and radio spots. The marketer knows much more about its potential customer such as demographics, what sites the customer previously viewed, etc…which is not available via traditional mediums. This allows the marketer to better customize more effective and niche advertising campaigns. In addition, a customer can click on an ad and instantly be able to order the advertised good in most cases. Obviously this is a capability that TV and radio can't match.

This is a space that Google and Facebook have dominated as it has grown. Due to the network effect, it is hard to imagine another entrant being able to displace either firm from its dominant position. While this is the main reason we want to have Alphabet in our portfolio, it is not the only one.

Other Assets:

The company brought in a new and experienced CFO from Morgan Stanley into the firm this year which has imposed some adult supervision to what has also been a startup culture. The changes she has already made have created shareholder value and will continue to do so in the future. She helped lead the charge to split off Google's more speculative businesses into separate companies for greater transparency. All companies that used to be a part of Google will now be separate companies under Alphabet which is now a holding company.

In addition, the new CFO has gotten expenses under control. In the last reported quarter expenses grew nine percent year-over-year down from 28% in the same period the prior year. Starting in the New Year the company will start to break out revenues from the main parts of the company. This should create shareholder value and a greater multiple for the stock just as it did when **Amazon (NASDAQ: AMZN)** started to break out the contribution from its web services division this year.



Source: Interactive Advertising Bureau, BI Intelligence Estimates

YouTube:

The company's YouTube ownership is an undervalued asset. Only Facebook as more than the 1.3 billion active users that YouTube can claim. This compares favorably to the 70 million subscribers that **Netflix (NASDAQ: NFLX)** can claim. YouTube is also seeing faster growth than either noting earlier this year that viewing time had increased 60% year-over-year while mobile viewership had doubled.

YouTube brings in some 15% of the company's overall revenue which is approaching $75 billion this fiscal year. That number could grow to 25% of overall revenue five years hence if the company can double revenue per YouTube user over that timeframe which seem eminently possible given how fast advertising dollars are migrating to digital channels especially video.

Think about this, YouTube is producing nearly $9 billion in revenue, more than $2 billion more than Netflix which has a market capitalization of $50 billion. Assigning a per user value along the lines of **Twitter (NASDAQ:TWTR)** to YouTube, which seems conservative, puts a $100 billion value on this part of the company's business or about 20% of the Alphabet's overall market capitalization. Not bad given YouTube was purchased for less than $1.7 billion nine years ago.

Driverless Cars & Web Services:

I could write a whole article on the potential for these nascent businesses but will do a quick summary. How fast driverless cars are rolled out and embraced by the market is the subject to much debate. Huge strides are being made and whether this happens a few years from now or a decade from now is a moot debate. It is pretty clear that a quarter century from now very few of us will actually be driving a car the "old fashioned" way. Google will be one of the key players in this potentially massive market given its early investments, patent trove, and technical edge.

Google internal data server farms would amount to the fourth largest web services business in the world if it was treated as a standalone entity. The company is just getting into supplying webs services to other businesses. It recently assigned a director of its board to lead this business who has extensive experience developing cloud based businesses. Web services is what powered huge gains in the stocks of **Microsoft (NASDAQ: MSFT)** and Amazon this year. As the company builds out its offerings, it has the same potential to power growth and shareholder value in the years ahead.

Summary:

The newly christened Alphabet as outlined above has many different growth drivers that bode well for continued creation of shareholder value in the years ahead. The company has also discovered financial discipline in 2015. Although not cheap, the stock is not expensive given its long term growth trajectory, unassailable position in search, rock solid balance sheet and the continued migration of the advertising dollar to the digital domain. It is a worthy new addition to the Blue Chip Gems portfolio and will replace **Micron Technologies (NYSE: MU)** in our optimized 20 stock portfolio.

Recommendation: Buy GOOGL up to $825.00 a share.

Position: Long GOOGL

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.

The market is limping to the close for 2015 as market indices have basically gone nowhere this year. Profits within the S&P 500 declined year-over-year for the first time since 2009 thanks to the collapse in energy profits, a strong dollar, and tepid overseas demand. It has been a largely forgettable year for investors as not much has delivered outsized performance outside of the FANG stocks. Given how stretched valuations have become for these growth stars, 2016 could well be a year that favors GARP (growth at a reasonable price) stocks with good balance sheets and solid dividend yields. That would position the Blue Chip Gems portfolio very well for the New Year.

Some of our positions are selling at very cheap levels looking at free cash flow. At current prices **Apple (NASDAQ: AAPL)** should deliver a nine percent free cash flow yield in 2016. **Gilead Sciences (NASDAQ: GILD)** should beat that with a 10% free cash flow yield. Expect both companies to buy back a ton of stock and increase their dividends in 2016. **Celgene (NASDAQ CELG)** should also start off 2016 on the right foot after resolving a patent dispute around its blockbuster blood cancer drug Revlimid last week. **Amgen (NASDAQ: AMGN)** certainly gave its shareholders some love to close out 2015, announcing a 27% dividend hike starting in the New Year.

Our financial selections should start to benefit from higher interest rates in 2016 as the Federal Reserve finally raised the Fed funds rate for the first time since 2006 this month. This could have huge impacts to banks' bottom lines**. Bank of America (NYSE:BAC)** recently estimated that a 100 basis point rise in rates would add some $4.5 billion in profits to its books.

In other news this month, the 40 year old export ban on crude oil was lifted. It could be expected that this will adversely impact the business fundamentals of refiners like **Valero (NYSE: VLO)**, but congress added some goodies to help these businesses to write off more of their transportation costs which ended up making the changes pretty much a wash.

We should start to get some better performance from some of the laggards now that tax loss selling has largely concluded**. Las Vegas Sands (NYSE: LVS)** seems poised for a much better 2016. Comparisons should be easier this year. In addition, its 3,000 room Parisian Macao should come on line providing another revenue stream as well as drastically reduced capital expenditure needs over the next couple of years. Its chairman recently said he expected a much better year in 2016 and Moody's upgraded the company's debt ratings as well. While we wait for improved performance, we get to collect a healthy six percent dividend yield.

We are tossing in the towel on **Micron Technologies (NYSE: MU)**, as that company is now more of a turnaround situation than a consistent growth play. Global demand in technology was one of the huge disappointments of 2015. In addition, despite the DRAM space being controlled by three companies, Samsung has not maintained pricing discipline like one would expect within an oligopoly. I expected consolidation in this space to result in better pricing structures ala the domestic airline space. Unfortunately, that thesis has proved to be incorrect and we are moving on from Micron even though I plan to continue to hold the shares in my own portfolio as the stock has long-term value. We will be replacing Micron with a name that can deliver more consistent growth in 2016 and beyond.

Micron Technologies will no longer be followed in Blue Chip Gems after this issue. It can now be found in the "Closed Positions."

With that, we come to the conclusion of 2015 here at Blue Chip Gems. I wish the entire Blue Chip Gems community a prosperous and healthy New Year.

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.
Alphabet (GOOGL)	12/28/15	$782.24	$782.24	-	N/A	N/A
Macy's (M)	11/24/15	$39.63	$35.50	3.7%	-10.4%	-1.6%
Merck (MRK)	10/27/15	$53.47	$52.84	3.3%	-1.2%	-0.5%
Allergan (AGN)	09/29/15	$254.87	$308.88	-	21.2%	9.2%
Amgen (AMGN)	08/28/15	$155.89	$161.73	2.0%	3.7%	3.4%
Bank of America (BAC)	07/28/15	$17.88	$17.13	1.1%	-4.2%	-1.8%
Celgene Corp. (CELG)	06/26/15	$117.92	$119.10	-	1.0%	-2.1%
Blackstone Group (BX)	05/18/15	$43.64	$30.41	6.3%	-30.3%	-3.4%
Qualcomm (QCOM)	04/15/15	$68.46	$49.58	3.9%	-27.6%	-2.4%
Capital One (COF)	04/15/15	$82.82	$73.15	2.0%	-11.7%	-2.4%
Express Scripts (ESRX)	03/18/15	$83.29	$87.95	-	5.6%	-2.0%
Foot Locker (FL)	03/18/15	$61.17	$65.26	1.5%	6.7%	-2.0%
AbbVie (ABBV)	02/13/15	$58.05	$58.75	3.7%	1.2%	-1.9%
Valero Energy (VLO)	02/13/15	$58.60	$70.62	2.8%	20.5%	-1.9%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$101.68	1.6%	1.0%	1.8%
Apple Inc. (AAPL)	01/16/15	$105.99	$106.82	1.7%	0.8%	1.8%
JPMorgan Chase & Co. (JPM)	01/16/15	$55.93	$66.38	2.6%	18.7%	1.8%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$44.12	5.8%	-19.6%	1.8%

Recent Price is updated from stock closings on 12/28/15

Closed Positions

Company	Entry Date	Entry Price	Close Price	Returns	Close Date
Micron Technologies (MU)	1/16/15	$28.99	$14.19	-51.1%	12/28/15

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: 12/28/15. 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.