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Investors Alley
Blue Chip Gems

Biotech and Any Company Not in Amazon's Crosshairs Will Continue to Outperform

Fellow Investor,

The market meandered somewhat in May after nice gains since the lows in February. Large caps were relatively flat on the month as small caps were where the action was in trading during May. This makes sense as global demand remains anemic with worldwide economic activity remaining at its lowest levels since 2009. Oil continues to rally with oil touching $50 a barrel this month after being about half that near the lows earlier in 2016.

In This Issue

While worldwide growth will probably remain tepid, domestic GDP growth seems to be picking up. After posting a disappointing 0.5% reading in Q1 (just revised to 0.8%), growth may come in near three percent for the second quarter according to the latest forecasts.

One part of the domestic economy that really seems to be getting traction is the housing market. April new home sales posted their best monthly reading in eight years and March home price increases were significantly above expectations. They has helped home based retailers like **Home Depot (NYSE: HD)** as well as more cyclical construction and homebuilding concerns which is a major theme that is playing out in the Small Cap Gems portfolio.

Unfortunately, retail overall remains a bifurcated market. Apparel and electronic retailers continue to face increasing competition from **Amazon (NASDAQ: AMZN)** as well as consumers not spending much of the gasoline "tax cut" in those areas. Some specialty retailers like **Ulta Salon (NASDAQ: ULTA)** have shown good results as they remain outside the online giant's focus areas.

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Technology continues to be a challenged sector as the industry heavyweights like **IBM Corp. (NYSE: IBM), Microsoft (NASDAQ: MSFT)** and **Intel (NASDAQ: INTC)** struggle with overseas demand where they get a good portion of their revenue as well as a strong U.S. dollar. Even **Apple (NASDAQ: AAPL)** saw its first year-over-year decline in revenue in 13 years in the first quarter as it was particularly hurt by a falloff in demand in China.

The energy sector has been a good one for investors in recent months. However, given the slashing of capital expenditures at energy producers, companies that depend on demand from this part of the economy are still struggling. I expect to that to remain the case as it is hard to see oil giants opening up the spigot again until we see significantly higher crude prices for a decent amount of time, something I don't see happening in 2016.

Crude has had its biggest rally in seven years (see chart on next page) but I don't see it climbing beyond $60 to $65 a barrel this year. At those levels, a lot of drilling activity, especially in the shale regions of North America, would come back on line increasing supply and knocking down the price. It would be beneficial if oil traded in a $45 to $60 range. This would be high enough to keep most energy producers with decent balance sheets out of dire financial straits and not high enough to disrupt growth in other areas of the economy that are benefiting from lower energy prices.

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Ending on a bright note, I expect biotech to continue break out of its deep bear market decline as M&A seems to be picking up and it is one of the few parts of the market where the large players are delivering solid revenue and earnings growth despite the challenging global backdrop. Pharma has also done well recently for many of the same reasons.

If you ever have a question or comment you can reach me at bret.jensen@investorsalley.com.

Thank you and Happy Hunting.

Bret Jensen
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P.S. Join me on **Tuesday, June 7th** for my live strategy and Q & A session, "How to Invest in Biotech for Maximum Gains with Minimal Risk". The session is FREE however attendance is limited to 500 and we're already filling up quickly. So if you're even remotely interested I suggest you go ahead and **click here to sign up**.

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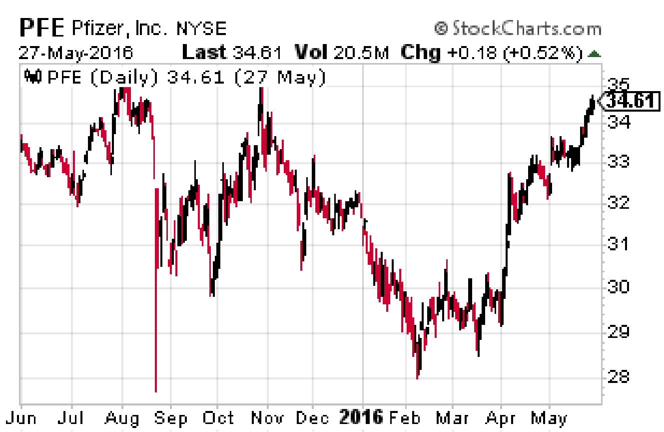
Pfizer is the Pill

The biotech and pharma sectors have started to behave better as of late after a deep and long bear market. Part of this is due to the fact that the large cap companies in these spaces are some of the few areas of the S&P 500 showing consistent earnings and revenue growth despite an anemic global backdrop. The healthcare sector overall is expected to deliver the best overall earnings growth in 2016 out of the ten industry sectors in the S&P 500. It is also the only one that will be close to delivering a 10% rise in profits this year.

The other factor that has improved sentiment on these sectors as of late is an uptick in M&A activity and speculation. This has started to gin up the "animal spirits" in these industries and has been a good thing as far as performance as of late is concerned. Our next portfolio addition has been a trigger point for that uptick. This pharma is known to most investors as it industry behemoth **Pfizer (NYSE: PFE)**. To make room for this industry stalwart, we are removing **JP Morgan (NYSE: JPM)** from the portfolio. The bank has been a solid performer gaining nearly 20% in its five quarters it has been in the portfolio, including dividends. Earnings estimates have come down some recently and it is less undervalued than it was in early 2015.



This has not been the year that Pfizer intended. Its huge $150 billion merger with **Allergan (NYSE: AGN)** was derailed recently by the U.S. Treasury Department on the third try. So called "tax inversions" have become a no-no in this election year. Ironically, I think this has improved the investment case on this pharma giant as it will now build out its portfolio making smaller acquisitions. This could gin up growth more effectively than the merger with Allergan. That tie up primary drivers were cost synergies and the tax advantages of moving the combined companies headquarters to tax advantaged Ireland.

Company Overview & Pipeline:

Pfizer has existed for over 150 years and if there is a more consistent, long term "Blue Chip" within the pharmaceutical industry, it is hard to name. The company has been on the forefront of drug discovery and development for many decades. Over the past six years, the company has completed 25 significant Phase III trials and had more than 15 significant drugs approved. It currently has eight compounds in registration phase, 30 ongoing Phase III trials and more than 50 Phase I & II trials started.

Once a stalwart in small molecule drugs like Lipitor which are easy to copy once they go off patent, the company has migrated to discovering and development of more complicated compounds which are harder to manufacture and do not have the same sales far off once they come off patent. Over 50% of the company's current pipeline consists of biologics, vaccines and biosimilars. This bodes well for consistent future growth after years of transitioning from flat and negative growth as it dealt with some important patent expirations.

One of the company's top sellers includes Prevnar, a vaccine is used to prevent infection caused by pneumococcal bacteria. It produced sales of over $1.5 billion last quarter, a better than 15% year-over-year increase.

Lyrica, which is indicated to treat fibromyalgia, diabetic nerve pain, spinal cord injury nerve pain and pain after shingles, produced some $1.2 billion in sales last quarter and is still seeing some growth.

Viagra and Lipitor chip in around $400 million a quarter. However, sales of Viagra are flat and Lipitor continues see mid-single digits sales declines as generic competition is robust.

Promising newer products include iBrance, a breast cancer treatment that should be approved for other indications in time. Its sales were up tenfold to over $425 million last quarter. Sutent which is used to treat advanced kidney cancer (advanced renal cell carcinoma or RCC) did almost $300 million in revenue last quarter and is seeing growth in the low teens.

Finally, Cantix/Champix used to induce smoking cessation saw an almost 40% sales increase last quarter to over $220 million.

A Bridge Too Far:

Although the acquisition of Allergan would have brought some solidly growing franchise products such as Botox into the portfolio, the merger would have primarily been done for cost synergies and more importantly tax advantages of moving the company's joint headquarters to much lower taxed Ireland. It also would have created an even larger more unwieldly behemoth. After being intently focused on getting through a regulatory gauntlet for more than a year, Pfizer finally "gave up the ghost" and bowed to political reality earlier this year. The company can now focus in growing its product portfolio via smaller more strategic acquisitions which should lead to faster and more consistent growth over the longer term.

Anacor: The Start of Acquisition Wave?

The company has shown it can make solid smaller acquisitions. Its purchase of Hospira in early 2015 for approximately $17 billion made Pfizer the leader in hospitable injectables and also brought in several biosimilar drugs Hospira was developing into its product pipeline profitable. The acquisition has turned out to be accretive and Pfizer believes the purchase will enable the company to cut annual costs by $800 million over its first three years. Hospira was a key reason that revenues grew 20% last quarter year-over-year and earnings per share rocketed ahead by 27%.

Earlier this month, Pfizer bought **Anacor Pharmaceuticals (NASDAQ: ANAC)** for $5.2 billion paying an approximate 55% premium over the current stock price at the time. However, even with the large premium the purchase price was a third less than the stock's 52 week highs. This attests to some of the bargains available in the small and mid-cap part of the biotech/biopharma sectors there are after their biggest bear market since the financial crisis.

Anacor's purchase enables Pfizer to pick up some low-risk assets. The first is the nail fungus treatment Kerydin currently marketed by **Novartis's (NYSE: NVS)** Sandoz division, and crisaborole, now dubbed Eucrysa and awaiting an FDA decision by January 7, 2017. EvaluatePharma forecasts Kerydin to pull in $66 million in royalties by 2022. Also according to EvaluatePharma, Eucrysa should earn $1.8 billion by then provided it is approved. Pfizer has estimated peak sales could at $2 billion. Quite the income stream for a purchase of just over $5 billion.

The company has a relatively unlevered balance sheet especially in light of what it would have looked like had it been successful with its tie up with Allergan. Pfizer easily can afford several more of these types of deals and I look for them to continue to take advantage of the some of the bargains in the small and mid-cap part of the market.

Valuation & Dividend:

Since the merger with Allergan was called off, the consensus earnings estimates for FY2016 have improved by 15 cents a share with the FY2017 projections improving by a dime a share. Continued small acquisitions should continue to boost future earnings growth. Pfizer should see ongoing annual earnings growth of five to 10% on a low to mid-single digit rise in revenues. This is a slight discount to the overall multiple of S&P 500 which is in the fourth quarter of its deepest "profit recession" since 2009. In addition, Pfizer pays a dividend yield of 3.5%. Since emerging from the financial crisis, dividends have been going up at an approximate 10% annual rate.

Outlook:

Pfizer is good solid single in a fairly or slight overvalued market. I expect over the next 12 months or so, Pfizer should growth earnings growth of five to 10% and also given its consistent growth should have its earnings multiple rise five to 10% as well. This should take us up to $40.00 a share which is the current S&P price target on Pfizer. Add in the dividend yield, and that is approximate 20% return.

Recommendation: Buy PFE up to $36.00 a share

Position: Long PFE

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Portfolio Update

As stated in the in the beginning of this newsletter, large cap stocks have done little since our last update even as higher beta sectors of the market like small caps and equities in the energy sector have headed nicely higher. Energy obviously is benefiting from a rebound in crude prices while small caps are being boosted by improving domestic growth in recent weeks. Large caps remain challenged by a strong U.S. dollar as well as the weakest overseas demand since 2009.

As one might say our portfolio was a very mixed bag this month. **Apple (NASDAQ: AAPL)** has fallen since our last update as the tech giant from Cupertino reported its first year-over-year decline in revenues for a quarter in 13 years. The company is challenged by a slowdown in demand from China and the first fall in global shipments of smartphones since the iPhone was introduced in 2007. Warren Buffett's Berkshire Hathaway took a large stake in the stock recently and the shares go for less than eight times earnings if one subtracts the cash on the balance sheet. Our other tech stock in the portfolio, **Qualcomm (NASDAQ: QCOM)**, headed in the opposite direction and gained almost exactly what Apple dropped in the last month.

Our retail stocks underperformed during the month as Amazon is taking more and more of the retail pie especially in retail. Consumers also seem reluctant to spend much of their gasoline "tax cut" in this area preferring increasing trips to restaurants looking at recent readings.

Meanwhile our financials have been in a slight uptrend despite a flat market. They should also benefit if and when the Federal Reserve hikes rates in June which is the current consensus. **JP Morgan (NYSE: JPM)** has been our strongest performer in the sector since our last update.

Pharma and biotech portfolio holdings have largely performed satisfactorily with the exception of **Gilead Sciences (NASDAQ: GILD)** which missed its quarterly numbers after eight straight quarterly beats. However, at these levels the stock is producing free cash flow yield of over 12%, is cheap on an earnings basis and pays an over two percent dividend yield. I expect the company to use its huge financial firepower to start to expand its portfolio outside its franchise HCV and HIV via acquisitions and collaboration deals in coming quarters. Elsewhere in the sector **Allergan (NYSE: AGN)** acquitted itself well as our newest addition to the portfolio and **AbbVie (NYSE: ABBV)** continues to be a strong performer as well.

Looking forward to June and the end of the second quarter of the year.

It seems the market has factored in and believes stocks can withstand an upcoming quarter point hike from the Fed which then will probably go into hibernation until after U.S. elections in November. It also looks doubtful the U.K. will vote to leave the EU on June 23rd, which would have roiled the global currency and equity markets. Finally, it appears that domestic GDP growth is picking up markedly in the second quarter compared with the anemic pace of the first quarter, a headwind equities could certainly use.

My view overall on the market for 2016 remains unchanged: equities should end the year flat or slightly down unless overall earnings growth picks up nicely in the second half of the year. This is something I don't see in the cards currently, but I would love to be proven wrong in this outlook.

As noted earlier, as of this issue we are taking profits on our position in JP Morgan (NYSE: JPM) for a 17% gain.

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Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Yield	Returns	S&P 500 Comp.
Pfizer (PFE)	05/27/16	$34.61	$34.61	3.5%	0.0%	0.0%
Allergan (AGN)	04/18/16	$219.91	$235.94	0.1%	4.6%	0.2%
Teva Pharmaceuticals (TEVA)	03/28/16	$53.85	$51.66	2.6%	-4.1%	3.0%
Synchrony Financial (SYF)	02/25/16	$27.78	$31.16	-	12.2%	7.6%
Wells Fargo (WFC)	01/25/16	$47.66	$50.85	3.0%	6.7%	11.8%
Alphabet (GOOGL)	12/28/15	$782.24	$747.60	-	-4.4%	2.1%
Macy's (M)	11/24/15	$39.63	$32.72	4.6%	-17.4%	0.5%
Merck (MRK)	10/27/15	$53.47	$56.48	3.3%	5.6%	1.6%
Amgen (AMGN)	08/28/15	$155.89	$156.74	2.6%	0.5%	5.5%
Celgene Corp. (CELG)	06/26/15	$117.92	$106.43	-	-9.7%	-0.1%
Blackstone Group (BX)	05/18/15	$43.64	$26.79	4.2%	-38.6%	-1.4%
Qualcomm (QCOM)	04/15/15	$68.46	$55.27	3.8%	-19.3%	-0.4%
Capital One (COF)	04/15/15	$82.82	$73.83	2.2%	-10.9%	-0.4%
Foot Locker (FL)	03/18/15	$61.17	$55.05	2.0%	-10.0%	0.0%
AbbVie (ABBV)	02/13/15	$58.05	$62.71	3.6%	8.0%	0.1%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$85.82	2.2%	-14.8%	3.9%
Apple Inc. (AAPL)	01/16/15	$105.99	$100.35	2.3%	-5.3%	3.9%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$46.19	6.2%	-15.8%	3.9%

Recent Price is updated from stock closings on 04/27/16

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Closed Positions

Company	Entry Date	Entry Price	Close Price	Returns	Close Date
JP Morgan (JPM)	01/16/15	$55.93	$65.43	17.0%	05/27/16
Valero Energy (VLO)	02/13/15	$58.60	$60.71	3.6%	04/18/16
Express Scripts (ESRX)	03/18/15	$83.29	$67.67	-18.8%	03/28/16
Allergan (AGN)	09/29/15	$254.87	$296.34	16.3%	02/25/16
Bank of America (BAC)	07/28/15	$17.88	$12.96	-27.5%	01/15/16
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: 05/27/16. 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.