July 2016 Vol. 2 Issue 7

Investors Alley
Blue Chip Gems

Adding a Stock from the Hot Housing Sector

Fellow Investor,

The market continues to creep slowly higher with the S&P 500 and Dow setting several all-time records over the past couple of weeks. As we move into the meat of the second quarter earnings season, 64% of companies reporting results so far are exceeding the consensus on the bottom line. Of course, keep in mind the long-run quarterly average is 66% as management and analysts engage in what I call the "analyst two step" where leadership helps "guide" expectations low enough that they can easily step over the consensus when it is time for the next quarterly report.

In This Issue

Still, profits are set for their fifth straight quarterly decline on a year-over-year basis within the S&P 500 when earnings season runs its course for the second quarter. The strengthening of the dollar since Brexit as well as a corresponding reduction in European growth prospects since the U.K. referendum are additional headwinds for upcoming quarters. Increasing terrorist acts on the continent are doing little to improve business confidence in a Eurozone economy that has struggled to remain just above stall speed for many years.

In addition, thanks partly to a stronger dollar, oil has moved much closer to $40 a barrel than to the $50 level it stood at a month ago. Investors looking for a continued rebound for the energy sector are likely to be disappointed and I remain heavily underweight this sector of the market right now.

The official election season has kicked off in front of what should be one of the nastiest presidential contests in memory given the high unfavorability ratings of both candidates. Given the strength in two fringe parties polling, don't be surprised if the "winner" of the contest does so with 45% or less of the popular vote. This will hardly be a "mandate" and will do nothing to alleviate the accelerating rancor in the country. This probably will not be good for markets and the uncertainty of the outcome will probably heighten volatility in equities.

Looking on the brighter side, the June Jobs Report showed nearly 300,000 net jobs created in the economy after May's report came in at under 20,000. Energy prices remain low putting more money in consumers' pockets. The fall in global yields since the Brexit vote has lowered 30-year mortgage rates to historical lows. This should continue to boost the improving housing market even as low yields are a major headwind for bank earnings as they erode net interest margins, a key component of profit. New home sales for June came in at an eight-year high. Manufacturing levels have improved of late as well even as the PMI Services Flash Report came in at its lowest levels in five years.

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In short, the economy continues to bifurcate even as we manage to muddle along at below trend growth supported by ultra-low interest rates. Not the best situation, but certainly better than the economies of the majority of the rest of the developed world.

If you have been having success with the Blue Chip Gems letter, I invite you to send me an email and let me know! Or, if you have a question or comment please email me at bret.jensen@investorsalley.com.

Thank you and Happy Hunting.

Bret Jensen
Editor
Bret Jensen's Blue Chip Gems

P.S. Finding biotech stocks with upcoming catalysts for explosive growth is a key component of my comprehensive strategy for massive profits in my newsletter, Biotech Gems.

And while I spend hours researching biotech stocks every week, I select only those meeting my stringent 6 point criteria developed over my decades-long successful biotech investing career.

Relypsa was a Biotech Gems portfolio holdings before it was bought out for a 60% premium. Many of my subscribers were able to book even bigger gains than that too. We held this stock for only 8 months. That's how fast you can make money with biotech stocks.

Right now, you can gain immediate access to 19 stocks just like Relypsa… stocks with the potential for immediate double – even triple-digit gains.

Whether you're new to biotech investing or feel like a pro you owe it to yourself to see how Biotech Gems can boost your portfolio.

I've finished up a short briefing on profit opportunities with Biotech Gems that can get you started.

Click here to find out more.

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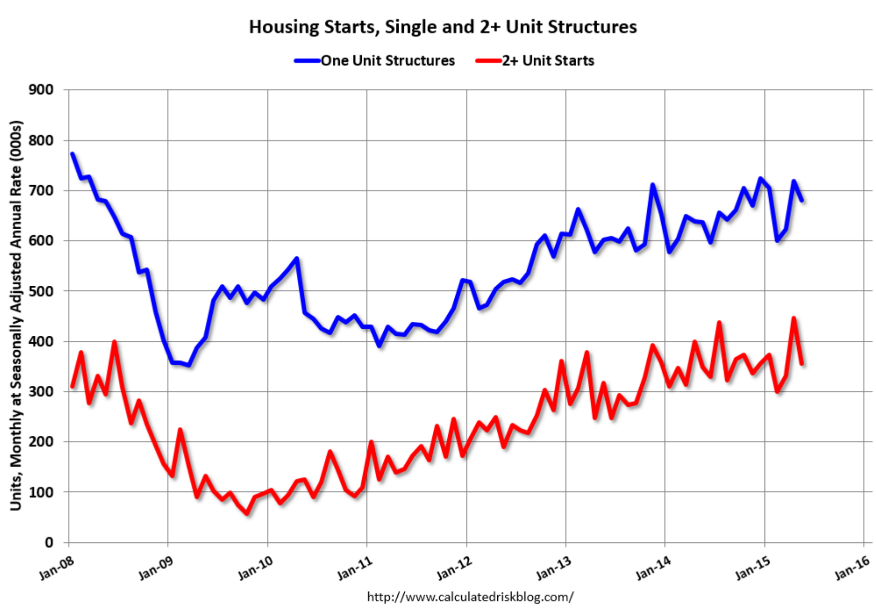
Gaining Exposure to the Hot Housing Sector

One of the themes that we have invested in heavily in the Small Cap Gems portfolio was that housing and construction were in the beginning of a long-term uptrend. We were a quarter or two early in that assessment. However, that heavy weighting in home builders and construction plays has paid major dividends for the portfolio in 2016 with myriad holdings up 40%, 50% or 60% so far this year.

The problem with investing in this theme is that most of the large cap names in the construction and engineering space like **Flour Corporation (NYSE: FLR)** are heavily exposed to the energy sector where demand is collapsing. Most home builders are small caps. However, there is one well-run and positioned home builder that has a $10 billion market capitalization where we can gain exposure to the improving housing market, and that is **Lennar (NYSE: LEN).** It will be replacing **Merck (NYSE: MRK)** in our portfolio. Merck has underperformed some of the other health care names in the portfolio but has produced a gain for us, including dividends.

Company Overview:

Lennar Corporation is one of the largest home builders in the country, primarily targeting single-family attached and detached homes to first-time, move-up, and active adult homebuyers. Lennar also develops multifamily rental properties. These are the main drivers of company revenue, but the company also offers a variety of financial services to investors and buyers that offer other revenue opportunities. Lennar has communities throughout the United States, has been in business for over a half century and is located in my neck of the woods also known as Miami, Florida.



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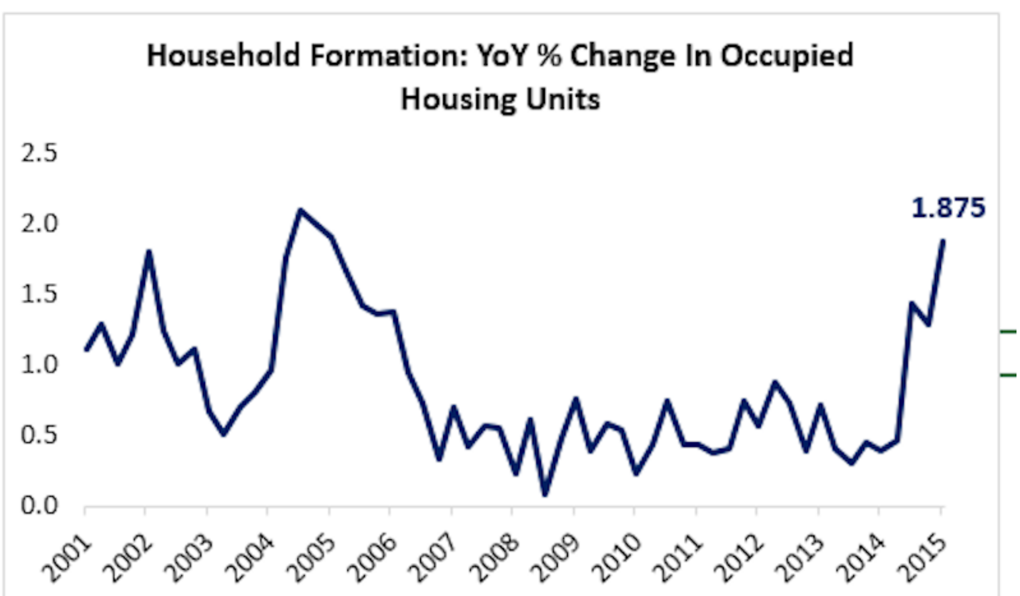
Housing Fundamentals:

Annual housing starts saw their best levels in 2015 since 2007 and are up again so far in 2016. New home sales in June were at an eight-year high as well. A solid job market, the beginning of some decent wage growth, historically low 30-year mortgage rates, and the loosening of mortgage credit standards are all tailwinds for the continued improvement in the housing market. Even though housing starts have risen significantly since the end of the financial crisis, they are far below the average of the past 30-40 years even as the population of the country continues to grow.

Household formation which shrank dramatically during the Great Recession is now back above where it was during the height of the housing bubble in the mid-2000s. This means there is plenty of pent up demand provided the country can continue to avoid a major economic downturn which seems likely. This should mean years of steady increases in housing activity even if the United States remains mired in the weakest post-war recovery on record.

In addition, the industry should benefit from whoever wins the upcoming election. Donald Trump made his fortune in real estate and it is hard to see how his policies would not encourage home building. Hillary Clinton will want to boost housing activity as a way to increase economic and job growth and to reward the various construction unions who provided support during the election. It truly is an industry that is politically agnostic at the moment. Meanwhile, because builders have been reluctant to be aggressive or lacked access to capital or bank credit lines, there has been a large deficit of home inventory both for sale or rent over the past few years. This is one reason average home prices are now within two percent of their 2007 highs. Lower mortgage rates however make monthly payments much more affordable than they were going into the financial crisis.



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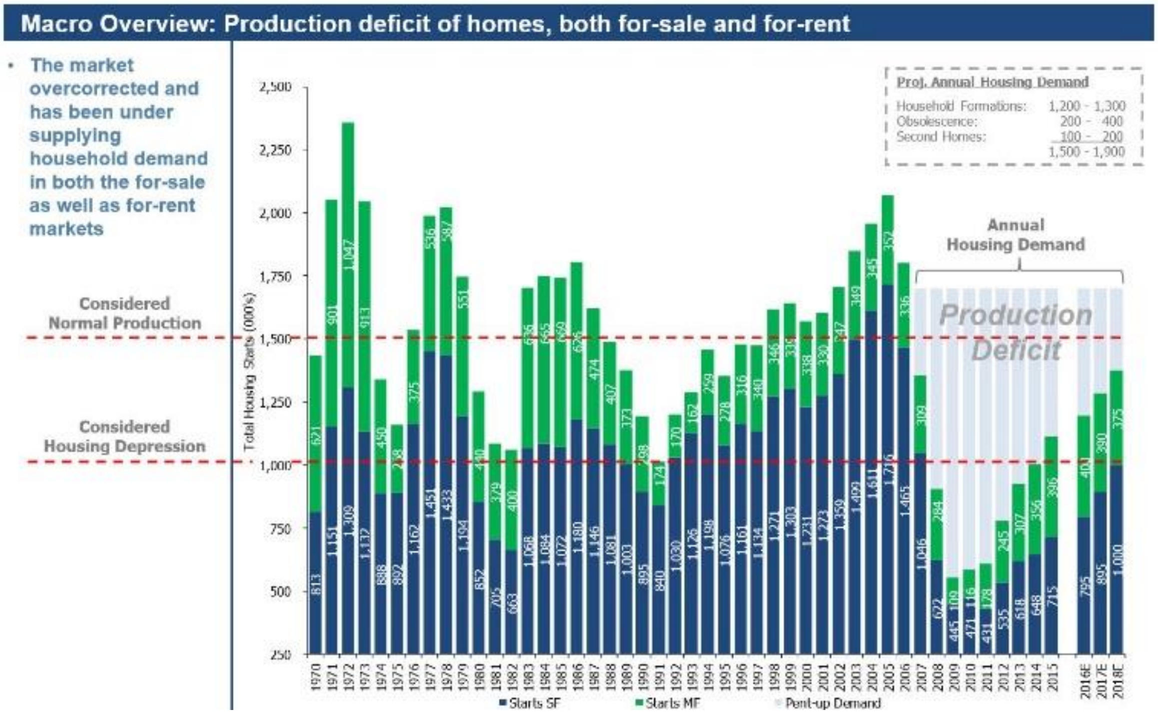


After the recession, homebuilder production took a steep dive and is just now creeping back up to what is considered normal levels.

Balance Sheet:

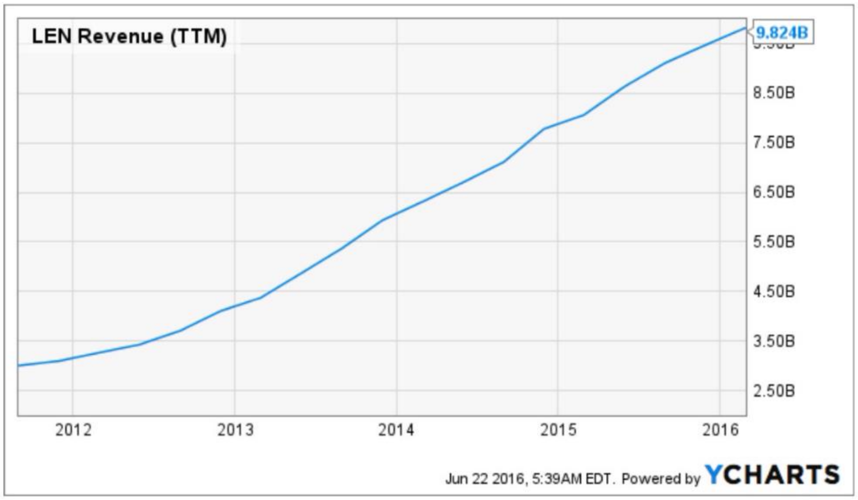
One of the main reasons I like Lennar is for its balance sheet as well as its financial flexibility and discipline. While many builders were selling off lot inventories in the financial crisis and its immediate aftermath at fire sale prices, Lennar's financial position allowed them to grab up a lot of these assets at bargain prices. This is a key reason that the company has the best overall margins among the large and mid-cap builders in the sector because it can build on the land assets acquired at lower prices.

The company's strategy is to be aggressive in the early part of any housing cycle such as 2010, aggressively buying up land and aiming for 15% to 20% annual growth. In mid-cycle it downshifts and lower the duration of their lot inventory by the use of land options and targets seven to ten percent yearly growth. As it approaches an end to a housing cycle, the company buys little land and shoots for just three to five percent growth. It is this discipline that helps Lennar avoid the trouble that traditionally has hit other home builders caught off guard at the end of previous housing cycles.

The company has already transitioned to a mid-cycle mindset which might prove conservative in the scheme of things. However, it is good to have that margin of safety in a cyclical industry. The company's solid leverage levels are already in a downward trajectory meaning that they are paying off their debt. If debt levels get too low, the company may choose to return cash to shareholder via stock buybacks.

Growth Prospects:

In the last reported quarter, the company beat both the top and bottom line consensus as revenues grew some 15% year-over-year with operating profits increasing at a 17% clip. As can be seen from the chart on the next page, the company has been delivering a consistent increase in annual revenues for a half-decade now. Earnings have grown comparably albeit at



a lumpier pace. Earnings this year should come in between $3.75 to $3.80 a share. At approximately $48.50 a share, this means Lennar is selling at under 13 times forward earnings, a significant discount to the overall market multiple despite revenues and earnings growing in the teens.

Analyst Commentary:

Analyst commentary on Lennar at the present time is positive. Over the past month, RBC Capital, UBS, and Argus Capital have reiterated Buy ratings with price targets in a fairly tight range of $59.00 to $64.00 a share. This looks quite reasonable over the next 12-18 months which would mean a return of approximately 25% above current levels.

Outlook:

Although not as fast growing as some of the small homebuilders that have done so well within the [Small Cap Gems portfolio]() this year like **LGI Homes (NASDAQ: LGIH),** Lennar has better geographical diversification and financial strength. It also has been around for over sixty years and has managed through myriad housing cycles. I expect this to be a holding that returns an average of 10% to 20% as long as the housing market continues to improve which I foresee for at least a few more years. In what I think might be a flat market over the next 12 months that is a solid return scenario.

Recommendation: Buy LEN up to $52.00 a share

Position: Long LEN

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Portfolio Update

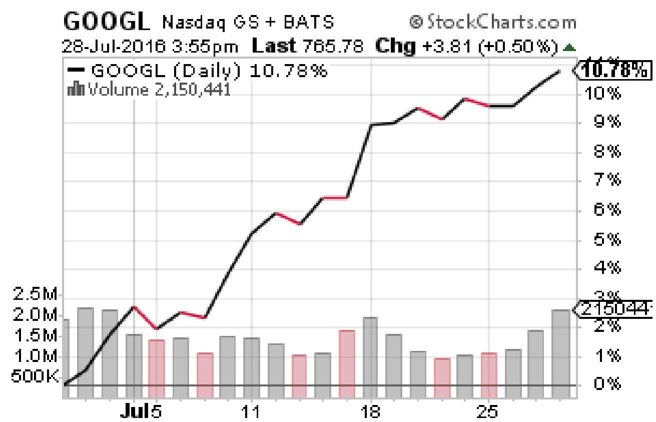
Despite myriad worries, the market has managed to grind up another couple of percentage points since our last Blue Chip Gems portfolio update. Second quarter earnings season has been somewhat hit or miss and we have had a couple of disappointments along with several stocks that have run up strongly over the past month. Overall, our portfolio handily outdistanced the overall S&P 500 over the past month.

On the disappointing side we have **Gilead Sciences (NASDAQ: GILD)** which actually beat the earnings per share consensus but came in on the light side as hepatitis C sales fell significantly in the United States and Europe. Also, the sickest populations are mostly treated in Japan which instituted some price control measures. On the bright side, revenues from the other parts of the company grew in the low teens and the company produced some $4.9 billion in operational free cash flow during the quarter. This equates to better than a 15% free cash flow yield. Hopefully, the fall-off in sales pushes the company to make a strategic acquisition which investors and analysts have been pushing it to do for some time. Even with the quarterly results, Gilead is just slightly down since our last update.

It was the only loser among our heavily weighted biotech and pharma positions, and we had strong performances from **Allergan (NYSE: AGN), Amgen (NASDAQ: AMGN), Teva Pharmaceuticals (NASDAQ: TEVA)** and **Celgene (NASDAQ: CELG)** which all had nice surges during July. **Merck (NYSE: MRK), Pfizer (NYSE: PFE)** and **AbbVie (NASDAQ: ABBV)** posted lesser gains.

Merck's position will be closed and we will no longer cover this stock after this issue. It can now be found in the 'Closed Positions' section.

Apple (NASDAQ: AAPL) saw its revenues drop substantially from a year ago but still beat expectations and saw its stock rise anyway. Our other tech plays, **Alphabet (NASDAQ: GOOGL)** and **Qualcomm (NASDAQ: QCOM)** also enjoyed very solid rallies during the month. **Las Vegas Sands (NYSE: LVS)** was also a big winner during July as the company stated it was seeing "stabilization" within the mass gaming market in Macau.



Despite what remains a challenging environment for retailers, both **Macy's (NYSE: M)** and newcomer, **Signet Jewelers (NYSE: SIG)** posted solid gains since our last update. **Foot Locker (NYSE: FL)** is up nearly 10% since our last Blue Chip Gems edition went out. Out of our financials, **Wells Fargo (NYSE: WFC)** was up slightly on the month even as its energy loans soured and its quarterly results slightly missed estimates. With historically low yields, it is very hard for banks to show any earnings growth given contracting net interest margins. Credit quality seems to be deteriorating slightly after consistently improving since the financial crisis as well. Despite this, **Capital One (NYSE: COF)** and **Synchrony Financial (NYSE: SYF)** had solid gains on the month as well.

Despite the fifth straight quarter of year-over-year profit declines, our portfolio came through July like a champ.

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Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Yield	Returns	S&P 500 Comp.
Lennar (LEN)	07/28/2016	$48.28	$48.28	0.3%	N/A	N/A
Signet Jewelers Ltd. (SIG)	6/29/2016	$82.00	$86.92	1.2%	6.0%	4.8%
Pfizer (PFE)	05/27/16	$34.61	$36.67	3.3%	6.0%	3.4%
Allergan (AGN)	04/18/16	$219.91	$255.56	-	13.2%	3.6%
Teva Pharmaceuticals (TEVA)	03/28/16	$53.85	$54.79	2.5%	1.7%	6.5%
Synchrony Financial (SYF)	02/25/16	$27.78	$27.91	-	0.5%	11.2%
Wells Fargo (WFC)	01/25/16	$47.66	$48.13	3.2%	1.0%	15.6%
Alphabet (GOOGL)	12/28/15	$782.24	$765.84	-	-2.1%	5.5%
Macy's (M)	11/24/15	$39.63	$35.87	4.1%	-9.5%	3.9%
Amgen (AMGN)	08/28/15	$155.89	$171.28	2.4%	9.9%	9.1%
Celgene Corp. (CELG)	06/26/15	$117.92	$111.26	-	-5.6%	3.3%
Qualcomm (QCOM)	04/15/15	$68.46	$62.43	3.5%	-8.8%	3.0%
Capital One (COF)	04/15/15	$82.82	$67.48	2.4%	-18.5%	3.0%
Foot Locker (FL)	03/18/15	$61.17	$59.27	1.9%	-3.1%	3.4%
AbbVie (ABBV)	02/13/15	$58.05	$64.72	3.5%	11.5%	3.5%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$81.24	2.1%	-19.3%	7.5%
Apple Inc. (AAPL)	01/16/15	$105.99	$104.34	2.4%	-1.6%	7.5%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$50.77	5.7%	-7.5%	7.5%

Recent Price is updated from stock closings on 07/28/16

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Closed Positions

Company	Entry Date	Entry Price	Close Price	Returns	Close Date
Merck (MRK)	07/28/16	$53.47	$58.43	9.3%	07/28/16
Blackstone Group (BX)	05/18/15	$43.64	$24.75	-43.3%	06/29/16
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: 07/28/16. 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.