

 Portfolio Monitor



Monthly Report for **Matthew Tae**

December 05, 2014

2014 Thesis Portfolio



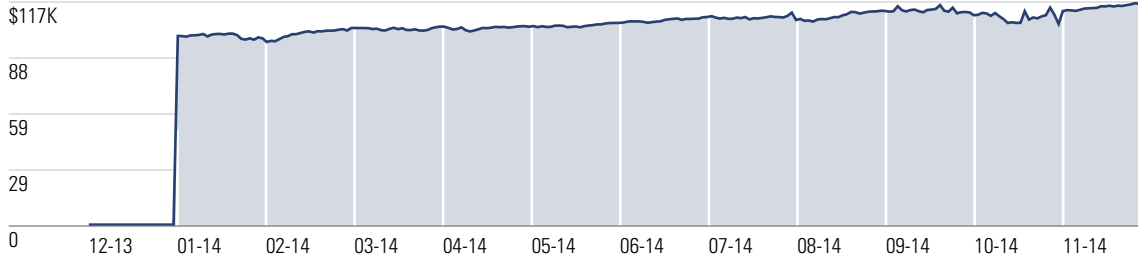
### 2014 Thesis Portfolio

Personal Morningstar Rating	Personal Return This Period	% of Mutual Fund Outperformed	Reporting Period
—	3.62%	—	Nov 2014

Previous Balance \$	112,933.47
New Net Investment \$	0.00
Gain/Loss \$	3,985.60
<b>Current Balance \$</b>	<b>116,919.07</b>

### Portfolio Performance

● Market Value



	1-Wk	1-Mo	3-Mo	YTD	1-Yr	3-Yr*	5-Yr*	10-Yr*	Sin. Purch*
Total Return %	0.93	3.77	2.48	17.46	—	—	—	—	17.46
Personal Return %	0.93	3.62	4.21	19.11	—	—	—	—	19.11
US Market Index Return %	0.19	2.30	2.67	12.04	—	—	—	—	12.04

\*Annualized

Re-Invested Dividends \$	0.00
Re-Invested Interest \$	0.00
Dividend \$ (Top 10)	
Total	0.00
Capital Gain/Loss \$ (Top 10)	
Total	0.00

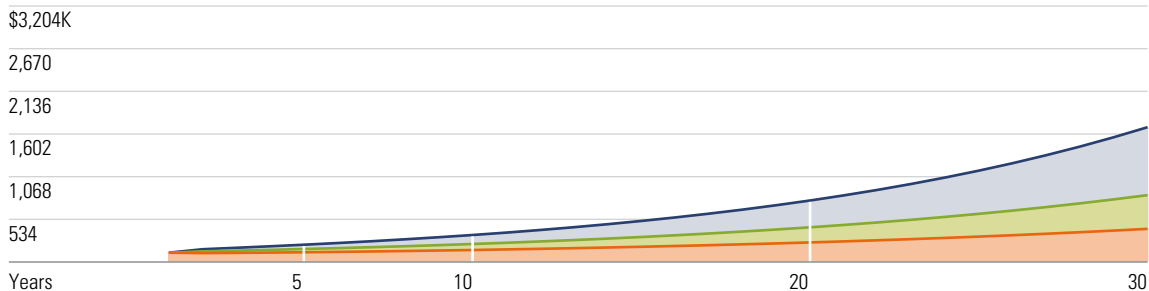
### Top 5 Gainers

Name	Morningstar Rating	Price \$	Market Value \$	1-Mo Return %
Macy's Inc	★★★★	64.91	9,736.50	12.26
Apple Inc	↓★★★	118.93	5,946.50	10.12
Kroger Co	★	59.84	2,992.00	7.41
Twenty-First Century Fox Inc C ...	↓★★★★	35.36	3,536.00	6.60
Technology Select Sector SPDR® ...	★★★★★	42.49	4,249.00	4.81

### Top 5 Losers

Name	Morningstar Rating	Price \$	Market Value \$	1-Mo Return %
Google Inc Class C	★★★★	541.83	4,876.47	-3.09
Twitter Inc	★★★★	41.74	4,174.00	-2.93
Alerian MLP ETF	★★	18.10	1,810.00	-2.58

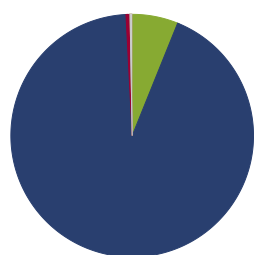
### Potential Value in 5, 10, 20 and 30 Years



Years	5	10	20	30
75% Chance	121,892	150,276	244,841	414,786
50% Chance	162,291	225,270	434,033	836,260
25% Chance	216,079	337,689	769,414	1,686,006

In this section we provide a hypothetical outlook on your portfolio's future performance highlighting the percent chance of achieving the values we project.

## X-Ray Overview



Asset Allocation	
Cash	6.39
U.S. Stocks	93.07
Foreign Stocks	0.54
Bonds	0.00
Other	0.00
Not Classified	0.00

Equity Investment Style			Size
Value	Core	Growth	
14	33	34	Large
3	3	6	Med
1	1	1	Small

Fixed Income Style			Credit Quality
Ltd	Mod	Ext	
0	0	0	High
0	0	0	Med
0	0	0	Low

## Diagnostics

### Asset Allocation

Your portfolio is aggressive. An asset mix such as yours normally generates high long-term returns but can be very volatile. Financial planners typically recommend these types of mixes for investors who have investment horizons longer than 10 years, need high returns, and are comfortable with a high level of risk.

### Equity Investment Style

Compared with the broader market, your portfolio's stock exposure is biased toward large-cap companies. Among these issues, it is worth noting that you have a good mix of conservatively priced value stocks and aggressively-priced growth issues. Depending on your investment goals, you may want to further diversify your portfolio by increasing your exposure to small- and mid-cap companies.

### Sector Weighting

- ◆ Over Exposure
- ◇ Under Exposure

### Fees & Expenses

The mutual funds in your portfolio tend to have below average expense ratios, which is good because expense ratios have been shown to be a major factor in mutual-fund performance over the long term.

### Regional Exposure

- ◆ Over Exposure
- ◇ Under Exposure

## Sector Weighting

	% Net Assets		1-Mo Return %		Portfolio 1-Mo Return %				
	Portfolio	S&P 500	Portfolio	S&P 500	-1.53	-0.77	0	0.77	1.53
<b>Cyclical</b>	<b>41.64</b>	<b>30.39</b>	<b>1.51</b>	<b>0.86</b>	◆				
Basic Materials	3.56	3.13	0.13	-0.02	◆				
Consumer Cyclical	◆ 29.09	10.18	1.05	0.48	◆				
Financial Services	◇ 7.53	15.01	0.27	0.33	◆				
Real Estate	1.46	2.07	0.05	0.07	◆				
<b>Sensitive</b>	<b>42.24</b>	<b>42.10</b>	<b>1.53</b>	<b>-0.18</b>	◆				
Communication Services	2.25	3.95	0.08	0.09	◆				
Energy	7.41	9.20	0.27	-0.68	◆				
Industrials	◇ 5.86	11.08	0.21	0.40	◆				
Technology	◆ 26.72	17.87	0.97	0.00	◆				
<b>Defensive</b>	<b>16.12</b>	<b>27.51</b>	<b>0.58</b>	<b>0.89</b>	◆				
Consumer Defensive	7.36	9.59	0.27	0.36	◆				
Healthcare	7.18	14.75	0.26	0.52	◆				
Utilities	1.58	3.17	0.06	0.02	◆				
Not Classified	0.00	0.00	0.00	—	◆				

## Stock Statistics

	Portfolio	Relative to S&P 500		Portfolio	Relative to S&P 500
Forward P/E Ratio	18.60	1.06	5-Yr Proj EPS Growth %	2.22	0.23
P/B Ratio	3.25	1.33	Dividend Yield %	1.36	0.82
ROA	8.12	0.99	Average Market Cap \$mil	55,253.83	0.77
ROE	19.89	0.94			

## Fees & Expenses

Average Mutual Fund Expense Ratio %	0.35	Estimated Mutual Fund Expense \$	212.69
Expense Ratio of Similarly Weighted Hypothetical Portfolio %	0.43	Total Sales Charge Paid \$	0.00

## Regional Exposure

% of Stocks		% of Stocks		% of Stocks	
North America	99.43	Europe Emerging	0.00	Asia Developed	0.07
Latin America	0.01	Africa/Middle East	0.00	Asia Emerging	0.09
United Kingdom	0.06	Japan	0.00	Not Classified	0.00
Europe Developed	0.33	Australasia	0.00		

Name	Ticker	Morningstar Rating	Change in Rating	% of Assets	Holding Value \$	Personal Return %				
						1-Mo	3-Mo	1-Yr*	3-Yr*	5-Yr*
SPDR® S&P 500 ETF	SPY	★★★★★	—	42.53	49,728.00	2.75	6.05	—	—	—
Macy's Inc	M	★★★★	0	8.33	9,736.50	12.26	—	—	—	—
Cash	CASH\$	—	—	6.29	7,350.70	—	—	—	—	—
Chipotle Mexican Grill Inc Cla ...	CMG	★★★★	0	5.68	6,636.20	4.02	—	—	—	—
Apple Inc	AAPL	↓ ★★	-1	5.09	5,946.50	10.12	20.44	—	—	—
Google Inc Class C	GOOG	★★★★	0	4.17	4,876.47	-3.09	—	—	—	—
Vanguard Small-Cap ETF	VB	★★★★★	—	4.00	4,674.00	1.05	—	—	—	—
Technology Select Sector SPDR® ...	XLK	★★★★★	—	3.63	4,249.00	4.81	-1.12	—	—	—
Panera Bread Co Inc Class A	PNRA	★★★★	0	3.58	4,185.00	3.56	—	—	—	—
Twitter Inc	TWTR	★★★★	0	3.57	4,174.00	-2.93	-0.89	—	—	—
Twenty-First Century Fox Inc C ...	FOX	↓ ★★★★★	-1	3.02	3,536.00	6.60	—	—	—	—
Kroger Co	KR	★	0	2.56	2,992.00	7.41	—	—	—	—
E I du Pont de Nemours & Compa ...	DD	★★★★	0	1.83	2,142.00	3.25	—	—	—	—
Enterprise Products Partners L ...	EPD	★★★★★	0	1.60	1,867.00	1.19	-8.96	—	—	—
Walt Disney Co	DIS	★★★★	0	1.58	1,850.20	1.24	—	—	—	—
Alerian MLP ETF	AMLP	★★	—	1.55	1,810.00	-2.58	-6.22	—	—	—
Facebook Inc Class A	FB	★★	0	1.00	1,165.50	3.61	—	—	—	—
Domino's Pizza Inc	DPZ	—	—	0.00	0.00	—	—	—	—	—
Cedar Fair LP	FUN	—	—	0.00	0.00	—	—	—	—	—
Market Vectors® Gold Miners ET ...	GDX	★	—	0.00	0.00	—	-9.25	—	—	—
Coach Inc	COH	★★★★★	0	0.00	0.00	—	-0.44	—	—	—
EOG Resources Inc	EOG	↑ ★★★★★	+1	0.00	0.00	—	—	—	—	—
Bristol-Myers Squibb Company	BMJ	★★	0	0.00	0.00	—	12.89	—	—	—
Citigroup Inc	C	★★★★	0	0.00	0.00	—	-4.55	—	—	—
Consumer Staples Select Sector ...	XLP	★★★★	—	0.00	0.00	—	—	—	—	—
Utilities Select Sector SPDR® ...	XLU	★★★★	—	0.00	0.00	—	—	—	—	—
Financial Select Sector SPDR® ...	XLF	★★	—	0.00	0.00	—	—	—	—	—
Industrial Select Sector SPDR® ...	XLI	★★★★	—	0.00	0.00	—	—	—	—	—
SPDR® S&P Transportation ETF	XTN	★★★★★★	—	0.00	0.00	—	—	—	—	—
Yahoo! Inc	YHOO	↓ ★★	-1	0.00	0.00	—	6.57	—	—	—
Health Care Select Sector SPDR ...	XLV	★★★★	—	0.00	0.00	—	—	—	—	—
Consumer Discret Sel Sect SPDR ...	XLY	★★★★★	—	0.00	0.00	—	—	—	—	—
Energy Select Sector SPDR® ETF	XLE	★★★★★★	—	0.00	0.00	—	-2.43	—	—	—
Yum Brands Inc	YUM	↓ ★★★★★	-1	0.00	0.00	—	—	—	—	—
Southern Co	SO	★★★★	0	0.00	0.00	—	—	—	—	—
iShares Nasdaq Biotechnology	IBB	★★★★★★	—	0.00	0.00	—	—	—	—	—
JC Penney Co Inc	JCP	—	—	0.00	0.00	—	-21.04	—	—	—
Whole Foods Market Inc	WFM	↓ ★★★★★	-1	0.00	0.00	—	-2.61	—	—	—
Materials Select Sector SPDR® ...	XLB	★★★★★	—	0.00	0.00	—	—	—	—	—
Molson Coors Brewing Co	TAP	↑ ★★★★★	+1	0.00	0.00	—	—	—	—	—
Walgreen Co	WAG	↓ ★★	-1	0.00	0.00	—	2.00	—	—	—

\*Annualized

**SPDR® S&P 500 ETF SPY** | ★★★★★**\$207.20** ↑\$5.54 | 2.75%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$207.89000</b>
Fair Value Estimate	<b>\$</b>
Consider Buying Price	<b>\$</b>
Consider Selling Price	<b>\$</b>
ETF Expected Return	<b>8.46%</b>
ETF Hurdle Rate	<b>9.97%</b>
ETF Expected Excess Return	<b>-1.51%</b>
Morningstar Coverage	<b>96.34% of assets</b>
	<b>444 of 503 Holdings</b>
Stock Quality (as % of assets)	<b>47.11% Wide Moat</b>
	<b>42.00% Narrow Moat</b>
	<b>7.12% No Moat</b>
Fair Value Uncertainty	<b>High</b>

11-18-2014 | by Michael Rawson, CFA

**The Thesis** 11-18-2014

## Suitability

SPDR S&P 500 SPY offers investors an efficient way to get diversified exposure to U.S. large-cap stocks. It is one of the most heavily traded securities in the world. This liquidity makes it very cheap to trade in large blocks, which attracts institutional traders and further lowers trading costs for the average investor. While the fund sports a low expense ratio, structural issues hinder its efficiency. There are better S&P 500 Index funds available.

The S&P 500 Index is the most oft-cited proxy for the U.S. equity market and is viewed as an indicator of the economic health of the nation. Although not as old as the Dow Jones Industrial Average, the S&P 500 is more diversified and market-cap-weighted, which makes it more representative of the U.S. market. Though it lacks exposure to small-cap stocks, the S&P 500 Index was nearly perfectly correlated with the broad U.S. market as represented by the Morningstar US Market Index during the past decade.

According to data from Ibbotson Associates, between 1926 and 2013, large-cap U.S. stocks returned 10.1% annualized compared with 5.5% per year for long-term government bonds. On an inflation-adjusted basis, a dollar invested in stocks would have grown to \$358.97 by the end of this period compared with just \$8.39 for a dollar invested in bonds during the same span. While stocks have had greater risk, their low correlation to bonds means that holding stocks in combination with bonds has resulted in superior risk-adjusted returns than holding either alone.

While an S&P 500 fund is suitable for any investor who wishes to include equities in his portfolio, a total market fund may be a better approach for most investors. In fact, Vanguard switched from using an S&P 500 fund to a total market fund within its target-date funds. Total stock market funds contain all market-cap segments, not just large caps. Holding all stocks within one fund can be more efficient than holding separate size segment funds for exposure to each market-cap segment as it should result in lower turnover. However, investors with a small position in equities may choose to use an S&P 500 Index fund and forgo exposure to small-cap stocks.

## Fundamental View

Over the long term, stocks have outperformed bonds, but with much greater risk. The excess return on stocks over the risk-free rate is called the equity risk premium, and it has averaged 6.5% annualized from 1946 through 2013. That soundly beat the

meager 1.4% excess return on long-term Treasury bonds during the same period. The extra return on stocks over bonds represents compensation for bearing risk. The annual volatility of the equity risk premium has averaged 17%, nearly twice that of long-term bonds. That high level of volatility on stocks can translate into periods of abysmal performance. Stocks fell 37% in 2008 and were negative in inflation-adjusted terms for the 16-year period from 1965 to 1981. Investors tend to panic during such times causing them to poorly time their investments, which can actually exacerbate negative market moves.

Market valuations can help improve expectations for future returns over the intermediate-term. Since 1946, the median price/trailing earnings ratio for the S&P 500 Index has been about 16 times. However, the average excess return on equities was only 3.2% in the years when the price/earnings ratio started above that median but 9.8% when starting from below median valuations. With the S&P 500 Index currently trading at a price/earnings ratio of 18.4, the future return to equities may be lower than the historical average. Low interest rates could support these above average valuations because future cash flows are worth more today when they are discounted at lower rates. However, low discount rates could also mean lower expected returns going forward.

Faster economic growth could also help justify current valuations. Consensus earnings forecasts call for 13% growth in earnings over the next two years, much higher than the 6% realized earnings growth over the past 10 years. Analyst forecasts are notoriously over-optimistic. It is hard to envision such rapid earnings growth when GDP growth is slowing. GDP growth in the United States averaged 3.6% from 1946 through 1999 but only 1.9% since that time. International growth could help, but the IMF recently cut its growth forecast for both emerging and developed economies outside the U.S.

Although stocks look a little expensive, they still look attractive relative to bonds. The price/earnings ratio can be inverted to form an earnings yield that can be compared with the interest rate on bonds. The median historical price/earnings ratio of 16 corresponds to a median earnings yield of about 6%, while the median interest rate on the 10-year U.S. Treasury note has been about 5%. The S&P 500 Index has a current earnings yield of about 5.4%, while the interest rate on 10-year Treasuries is 2.3%. This 3.1-percentage-point spread suggests that stocks are attractively valued relative to bonds.

Morningstar equity analysts cover 445 of the stocks in the S&P 500 and their estimate of the fair value of each stock can be aggregated to the index level to provide an additional gauge of market valuation. Currently, they see the market trading at a price/fair value of about 1.02. While this level is approximately fairly valued, it is much higher than the 0.93 price/fair value that it traded at toward the end of 2012.

**Fees & Alternatives**

This ETF's 0.094% expense ratio, while low in absolute terms, is not the lowest among ETFs tracking the S&P 500 Index. During the past five years, the fund has lagged the S&P 500 Index by about 13 basis points. Thus, the estimated holding cost is slightly higher than the expense ratio.

## Alternatives

SPY has greater trading volume and assets under management than any other ETF, which result in low market-impact cost. Given its abundant liquidity, frequent traders and investors moving tens of millions of dollars will likely prefer to use SPY over its closest peers.

While SPY is structured as a unit investment trust, iShares S&P 500 Index IVV is a Regulated Investment Company, which allows it to reinvest dividends, engage in securities lending, and use index futures if necessary--all of which result in lower estimated holding costs. Not only does IVV have a slightly lower expense ratio (0.07%), it also has realized lower all-in holding costs in practice. At just 0.05%, Vanguard S&P 500 VOO is the lowest-cost way to track the index for buy-and-hold investors.

Investors looking to complement this fund with an allocation to smaller-cap stocks might consider Vanguard Extended Market Index ETF VXF, which covers all stocks outside the S&P 500 and levies an annual fee of 0.10%. Vanguard Total Stock Market ETF VTI may be more appropriate for investors looking for exposure to the

broad U.S. market in one fund. With its full coverage of small-, mid-, and large-cap stocks and rock-bottom 0.05% expense ratio, it is one of our favorite U.S. equity ETFs.

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**Portfolio Construction**

This fund tracks the S&P 500 Index, a market-cap-weighted benchmark composed of large- and mid-cap U.S. stocks. The index has a slight quality tilt because of its conservative eligibility requirements pertaining to unprofitable companies and recent IPOs. However, that does not mean that the index will have superior performance or that unprofitable companies will be removed from the index on a timely basis. Constituents are determined by a set of criteria and an index committee, which has greater flexibility than most indexes that follow more mechanical rules. The minimum market cap for companies in the index is around \$4 billion. Though it lacks exposure to small caps and has limited exposure to mid-cap stocks, the constituents of this index account for 80% of the total market capitalization of the U.S. stock market. As this fund holds large stakes in multinational firms, it also has substantial indirect international exposure. About 46% of the index's constituents' revenues are generated outside of the U.S. Unlike most modern exchange-traded funds, SPY is organized as a unit investment trust, which prevents it from reinvesting dividends, holding securities that are not in the index, such as futures, or lending securities. This leads to slightly higher holding costs. It also has a one-month lag between the ex-date and the payment of dividends. The fund follows a full replication strategy, holding every stock in the index.

# Macy's Inc M | ★★★

\$64.91 ↑\$7.09 | 12.26%

Fair Value Estimate	<b>\$56</b>
Consider Buying Price	<b>\$33.6</b>
Consider Selling Price	<b>\$86.8</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>None</b>
Stewardship Grade	<b>Standard</b>

08-14-2014 | by Paul Swinand

## Analyst Note 11-12-2014

We continue to rate Macy's as having no economic moat and a stable trend, and we are making no change to our \$56 fair value estimate. We think the shares, trading in the 3-star range, are fairly valued. Third-quarter results showed sales comparisons are getting tougher year over year, with comparable-store sales falling 0.7%, but profitability is still improving as the operating margin reached 7.7%, compared with 7.1% in the prior-year period. However, the firm lowered its full-year earnings per share guidance to \$4.25-\$4.35 from \$4.40-\$4.50; this compares with our own estimate of \$4.49. Macy's has made steady progress on operating margins since the recession, and despite being later in the operations improvement process and ongoing investments to drive online selling and engagement, we believe management can continue to uncover opportunities for the next several years. Our long-term forecast calls for 2%-3% top-line growth and operating margins exceeding 10% for the next several years before falling back closer to historical averages (8.5% excluding 2008) by the end of our 10-year forecast. In the quarter, same-store sales fell 0.7% including the departments that were licensed. Excluding departments licensed this past year (notably Finish Line), company comparable sales fell 1.7% and total sales fell 1.3% due to the mix of store openings and closings during the prior 12 months. We believe some of Macy's flagship locations are unique in a retail portfolio and hold some competitive advantages for wholesale and licensing partners. Management said some marketing expenses shifted from the third quarter into the fourth, but still was pleased with the SG&A leverage that came despite the soft sales. It believes weather played a factor too and noted that the comparison was tough with the third quarter of 2013, but also believes consumers remain cautious. Omnichannel work continues, and over the long term we believe it can continue to be accretive to operating margins.

## The Thesis 08-14-2014

Department stores continue to be relevant, but because of competition, macroeconomic cycles, and low customer switching costs, we believe it is difficult for most retailers to develop long-term sustainable competitive advantages. Nevertheless, we believe Macy's is stronger than it was before the financial crisis and well positioned to serve the American middle class, from millennials seeking fashion to families shopping for homegoods. The company has been benefiting from its My Macy's localization initiative, which organizes stores into 69 districts, placing key management in local markets while centralizing back-office functions. The strategy creates a more relevant retail experience for customers and improves economies of scale that leverage Macy's national size and status. We think this and other operational improvement programs can continue to affect results, as they are still only a bit more than halfway rolled out in the chain, and the effect of shoppers returning after positive experiences could carry on for several seasons. The My Macy's strategy should continue to improve flexibility and foresight into inventory and markdown levels, which over the long run should improve gross margins and reduce downside risk should the economy slow again. With lower fixed overhead

cost, the company can allocate more resources to regions that are improving. At the same time, Macy's can now better leverage its size and national presence in advertising and marketing and also in vendor and landlord concessions. We think this puts Macy's in a position to gain some market share in the medium term. National scale, monobrand stores, and investments to standardize inventory management across channels have enabled further integration of online and stores, which continue to be a driver of growth, and longer term should contribute to gross margin improvement as buy-online-pick-up-in-store reduces shipping cost and central inventory reduces markdowns. In our view, Macy's has been particularly strong in expanding omnichannel capabilities, and is ahead of the competition, which has had important implications for connecting with a new generation of customers.

## Valuation

Our fair value estimate remains \$56 per share, which implies 13 times 2014 year-end (January 2015) earnings estimates. On an enterprise value/EBITDA basis, we value Macy's at 6.3 times 2014 EBITDA, with free cash flow averaging a 10% yield. Macy's maintained guidance for earnings per share of \$4.40-\$4.50, but reduced same-store sales forecasts for the full year to 1.5%-2.0% growth based on the first-half underperformance. For 2014 we model sales of \$28.6 billion, representing 2.4% growth year over year as the company's push to localize its merchandising continues to gain traction, as online sales continue to gain, but with virtually no store square footage growth. We believe these initiatives will continue to work into later years, and can still bring benefits independent of cost-cutting efforts that took place in 2013 and are now providing SG&A benefits. We project sales growth to average in the low-single digits over our explicit 10-year forecast, and note that the company expects to open only four net new stores through 2016. Sales growth combined with \$100 million in annual savings from the previously mentioned 2013 cost-cutting efforts should drive improved cash flows and earnings this year, along with control of working capital. We project operating margins to equal 10.2% in 2014 up from 9.9% last year, and then to normalize in the low-double digits to high-single digits over a longer horizon. Our model forecasts midteen returns on invested capital over the next several years, above our 8.4% cost of capital assumption, which is affected by the debt in the capital structure. We also note that the goodwill from prior mergers and store leases lowers return on capital to the high single digits.

## Risk

We've assigned Macy's a high uncertainty rating. Any weakness in consumer spending could weigh on performance, as Macy's serves mostly middle-class consumers and has a high correlation to the national economy. There is also risk from underperforming stores and stores in weak or declining malls, which could continue to deteriorate, especially if they are located near declining or stagnating demographic areas. Additionally, specialty retailers and more value-oriented department stores could continue to eat away at the market share of traditional department stores. Macy's has had success with the development of in-house and exclusive brands. But it faces the risk that consumers might change tastes and preferences, and the brands Macy's has developed might fall out of favor. As Macy's customer base ages, the company must constantly reinvent new brands to attract the next generation, and there can be no assurance that these new brands will be as successful. Over its long history, Macy's and the former department stores that merged to form the current entity have struggled after acquisitions. While no deals are likely or obvious in our view, the spotty record of mergers and acquisitions pose risks for Macy's and the industry. Failed mergers can lead to sales and margin volatility because of price competition in the industry. Post-merger integration can lead to management distraction and operational challenges for acquirers. Further restructurings from national competitors such as Sears also pose risks. Today, many retailers are investing in expanding outlet store concepts, while Macy's has only the Bloomingdale's outlets. But we believe the segment could slow on tough comparisons and as the industry eventually overbuilds outlet retail locations. Should Macy's ramp up its Bloomingdale's outlets, it runs the risk of expanding into a market that has already seen a large surge of capacity additions.

**Management & Stewardship**

Terry Lundgren is CEO and chairman. He has served as CEO since 2004 and has spent more than 25 years with the company in two stints. He had been COO and chief merchandising officer, including roles prior to the merger with Federated. We like that Lundgren is required to own stock that is 5 times his base salary, and we also believe the company's performance targets are balanced and well constructed. We think this helps to align his interests with those of shareholders. The board also has instituted one-year director terms, as opposed to its prior policy of three-year stints. This gives shareholders more flexibility to oust an underperforming board member, and puts pressure on management to perform since an outsider could more easily gain control, in our opinion. Additionally, the majority of the directors are independent, and as part of their compensation they are required to own shares of stock worth at least 5 times the annual cash retainer, which should motivate them to act in the interest of shareholders. Overall, we rate Macy's stewardship as standard.

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**Profile**

Macy's operates about 840 Macy's and Bloomingdale's stores in the U.S. and Puerto Rico, as well as Macys.com and Bloomingdales.com in 45 states, Guam, and Puerto Rico. Its stores are primarily in malls and sell family apparel, accessories, cosmetics, home furnishings, and other consumer goods.



# Chipotle Mexican Grill Inc CMG |



\$663.62 ↑\$25.62 | 4.02%

Fair Value Estimate	<b>\$600</b>
Consider Buying Price	<b>\$360</b>
Consider Selling Price	<b>\$930</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

10-27-2014 | by R.J. Hottovy

## The Thesis 10-27-2014

Not all fast-casual restaurant concepts are created equal. With a simple but uniquely customizable menu featuring naturally raised and organic products and aesthetically pleasing restaurant designs, Chipotle has developed a powerful brand intangible asset, the basis for our narrow moat rating. In turn, this has helped to drive industry-leading comparable sales and restaurant-level margins during a lackluster environment for most restaurant operators the past few years. Additionally, by sourcing from local ranchers and farmers, Chipotle has more clout over its suppliers than chains of comparable size. Although many restaurant concepts have looked promising early before succumbing to overextension or competition, we are optimistic that it will continue to balance growth with profitability, creating excess economic returns in the process. With \$3.2 billion in sales during 2013, Chipotle is the dominant player in the \$7 billion-plus domestic fast-casual Mexican restaurant category and one of the largest players in the \$35 billion domestic fast-casual restaurant category. We expect fast-casual restaurants--which offer higher-quality ingredients than quick-service chains but at lower average prices than casual dining restaurants--to grow nearly 10% annually the next few years because of a compelling consumer value proposition and strong unit economics (lower real estate and labor costs than casual dining operators). This exceeds our low-single-digit growth forecast for the broader restaurant industry. In our view, Chipotle can outpace its fast-casual peers. If the chain can match the density of its home market in Denver, we estimate that it ultimately could expand to 4,000 domestic units before nearing saturation (compared with more than 1,700 today), implying double-digit unit growth for several years. New restaurant prototypes that require less capital and have lower occupancy costs could provide entry into secondary markets and push this number even higher. We also find Chipotle's secondary concepts (ShopHouse Asian Kitchen and Pizzeria Locale) and international growth plans intriguing, but it will take years before these initiatives have a cash flow impact.

## Valuation

We are raising our fair value estimate to \$600 from \$570 due to a modest increase in our near-term revenue growth and operating margin outlook based on recent comparable traffic trends. Our updated fair value implies fiscal 2015 price/earnings of 33 times, enterprise value/EBITDA of 17 times, and a free cash flow yield of 2%-3%. Although we believe the market's implied long-term growth expectations appear mildly aggressive, we remain optimistic about near-term comp momentum due to the aforementioned menu price increases, ongoing peak-hour throughput efforts, and contribution from catering services. Based on 17% comps and contribution from 190 new restaurants (12% unit growth), we anticipate top-line growth of 28% during 2014. Looking to 2015, management's guidance calling for 190-205 restaurant openings and low-single-digit food cost inflation (relative to third-quarter levels) appears realistic and is aligned with our model. However, the company's same-store

sales target in the low-to-mid-single-digit range appears extremely conservative, especially when considering that the 6% price increases will provide a tailwind through much of the first half of the year. We remain comfortable with our 2015 comp outlook in the low-double-digit range and believe there is sufficient consumer demand to support high-teen average annual revenue growth the next five years, including low-double-digit unit growth and high-single-digit comps. The leverage inherent in Chipotle's restaurant model continues to impress. We expect restaurant margins to exceed 30% within five years (compared with 26.6% in 2013), putting Chipotle in the upper echelon of all industry operators. Food costs remain a headwind in certain categories, but we believe the company will continue to leverage labor and occupancy costs and post roughly 100 basis points of restaurant margin expansion to 27.6% this year. Our model assumes operating margins of 17.4% for 2014, compared with 16.6% in 2013, driven by restaurant margin gains but partly tempered by increased marketing costs. Over a longer horizon, we expect margin expansion, based on expanded rollout of the lower-cost "A model" restaurant prototype, and G&A expense leverage. Our model assumes operating margins improve to 22% over the next five years. ROIC (including capital leases) should improve to the mid-20% range (compared with our 10.0% cost of capital assumption), reinforcing our narrow economic moat rating.

## Risk

In our view, Chipotle's most significant risk is increased competition on several fronts. Some quick-service restaurant chains are upgrading their menus and decor, while many casual-dining firms have become more focused on enhancing their value proposition. Additionally, with retail landlords looking for tenants for unoccupied real estate and restaurant operators finding themselves with easier access to capital, we believe new fast-casual restaurant entrants will increasingly come to the market over the near future. This includes an emergent group of more upscale fast-casual players such as LYFE Kitchen, Mendocino Farms, Piada, and others that could target Chipotle's affluent and millennial audiences. If its brand appeal isn't as wide as we believe, Chipotle could face market saturation sooner than anticipated. Demographic shifts, an increasing number of meals prepared at home, and ongoing consumer-spending headwinds could dampen top-line results. Food, labor, energy, and occupancy cost volatility could disrupt results. Chipotle's secondary concepts, including ShopHouse Southeast Asian Kitchen and Pizzeria Locale, and international expansion carry their own set of execution risks.

## Management & Stewardship

Chipotle features a seasoned management team with a great deal of restaurant industry experience. Chairman and co-CEO Steve Eells, who holds a degree from the Culinary Institute of America, founded Chipotle in 1993. President and co-CEO Montgomery Moran formally joined the firm in early 2005, but had long served as Chipotle's general counsel. CFO Jack Hartung, a two-decade veteran of McDonald's, has been with Chipotle since 2002. Eells beneficially owns about 1% of the total equity (Class A and B common shares were collapsed into a single class of stock in December 2009) while Moran owns around 1.4%, providing enough of an incentive to increase shareholder value, in our view. Although we'd prefer the roles of chairman and co-CEO to be split and the board to declassify, we have not witnessed any abuses of power under this corporate-governance structure. Chipotle historically has been a solid allocator of capital, with the majority of free cash flow used to fund growth initiatives, namely high-return restaurant openings. Management also has been opportunistic with share repurchases, buying back \$622 million (an average overall price of \$153 per share) over the past five years. However, given the lofty price at which recent shares have been purchased, we'd prefer that value be returned to investors in the form of a dividend, which limits our equity stewardship rating to Standard.

## Profile

Chipotle Mexican Grill is the largest player in the \$7 billion-plus domestic fast-casual Mexican restaurant category. Its menu includes burritos, bowls, tacos, and salads made from higher-quality ingredients than at quick-service restaurants. Because

customers can choose from four different meats, two types of beans, and an array of extras, more than 65,000 menu combinations are possible. As of September, the firm operated almost more than 1,700 restaurants in 44 states, Canada, the United Kingdom, France, and Germany.

# Apple Inc AAPL | ★★

\$118.93 ↑\$10.93 | 10.12%

Fair Value Estimate	<b>\$100</b>
Consider Buying Price	<b>\$60</b>
Consider Selling Price	<b>\$155</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

10-22-2014 | by Brian Colello, CPA

## The Thesis 10-22-2014

We believe Apple's strength lies in its experience and expertise in integrating hardware, software, services, and third-party applications into differentiated devices that allow Apple to capture a premium on hardware sales. Although Apple has a sterling brand, strong product pipeline, and ample opportunity to gain share in its various end markets, short product life cycles and intense competition will prevent the firm from resting on its laurels, or carving out a wide economic moat, in our opinion. We believe Apple has developed a narrow economic moat, thanks to switching costs related to many attributes around the iOS platform that may make current iOS users more reluctant to stray outside the Apple ecosystem for future purchases. In our view, much of Apple's exponential growth in recent years has stemmed not from the firm's economic moat, but from the achievement of building the first truly revolutionary smartphone, the iPhone, that integrated hardware and software, as well as a robust apps store and ecosystem that attracted new users to platform. Apple's first-mover advantage may be diminishing, and "easy growth" coming from early smartphone adopters may be winding down as the smartphone market moves up the adoption curve and competition ramps up. Yet we still foresee iPhone growth, coming from both attracting new customers to iOS (mostly in emerging markets, although we still see U.S. growth as well) and retaining Apple's existing premium iPhone customers, where we think the company's moat will play an increasingly important role. A partnership with China Mobile, the world's largest wireless carrier, should also give iPhone growth a shot in the arm. Ultimately, we think future smartphone and tablet competition will stem from software and services, as hardware is already approaching commoditization. We view Apple as well positioned to develop and expand enough services to enhance the user experience, in order to build switching costs that will help the firm retain customers and generate significant repeat purchases will be critical for future iPhone growth in the years ahead.

## Valuation

We are raising our fair value estimate for Apple to \$100 per share from \$93, as we are more optimistic about long-term iPhone sales growth, in light of the firm's stellar near-term results around the iPhone 6 and 6 Plus launch. Our fair value estimate implies fiscal 2015 (ending September 2015) price/earnings of 13.6 times (and only 11 times after excluding Apple's cash balance on hand). We project 11% revenue growth in fiscal 2015, as we project 15% iPhone revenue growth due to a tremendous new iPhone launch. We model 9% Mac revenue growth and contribution of over \$3 billion in revenue from Apple Watch in fiscal 2015. Longer term, Apple should still attract late smartphone adopters in developed markets and new customers in emerging markets (especially China). As more consumers are previous smartphone owners, rather than first-time buyers, we think Apple has a good chance to retain a sizable portion of its iOS user base today, and perhaps gain further share at the high end of the market. We model average iPhone revenue growth of 5% per year over the next few years, above our prior expectations. Apple's strategy of

staying at the high end of the smartphone market bodes well for future profitability, but might be the greatest headwind to tremendous iPhone unit sales growth. Based on recent lackluster iPad sales, we project iPad revenue to decline by 9% in fiscal 2015, partially due to the iPhone 6 Plus potentially cannibalizing the iPad Mini. We model relatively flattish iPad revenue thereafter. We anticipate intense competition in the tablet space, as well as headwinds to tablet adoption, as more customers simply opt to rely on large-screen smartphones rather than stand-alone tablets. We model modest long-term revenue growth from Mac, up from our prior estimates, as the firm gains share in the declining PC industry. We do not make any profitability assumptions for any unannounced products, such as a long-rumored, revised Apple TV, but we recognize that future innovations may provide upside to our valuation. We project 38% gross margins in fiscal 2015, as well as mid- to high-30% gross margins in the long term. In turn, operating margins hover in the mid- to high-20% range. Our fair value uncertainty rating for Apple remains high.

## Risk

We believe a large, well-diversified company like Apple faces several risks. Smartphone and tablet competition is rising, as Samsung, in particular, has developed compelling iPhone alternatives in the premium smartphone space. Meanwhile, we anticipate that a greater portion of smartphone sales come from low-end devices in emerging markets where Apple does not participate. If these devices turn out to offer only a slightly worse user experience than iOS products, Apple may be unable to capture an adequate premium on future hardware sales. Apple also has to square off against several competitors with different strategies and financial profiles, as firms like Amazon (with its Kindle Fire tablet), Google (with its Nexus devices) and Xiaomi appear willing to sell hardware at close to cost, in order to drive other revenue streams. Despite its intentions to control as much of the user experience as possible for its products, Apple still relies on a robust app developer base and strong partnerships with third parties. Its decision to use an in-house mapping solution (and subsequent apology) may have diminished Apple's reputation and its customers' user experience, and other similar missteps may cause customers to leave the iOS ecosystem altogether. If Apple were to falter and its exceptional brand be diminished as customers departed iOS in droves, we're not even sure that Apple's mighty cash cushion could help the firm buy its way out of any problem. As a premium phone supplier, Apple also runs the risk that wireless carriers could reduce or eliminate the subsidies that they provide their customers on the iPhone, in turn raising customers' up-front costs and perhaps making other smartphones appear to be better alternatives. Finally, Apple lost cofounder and visionary Steve Jobs in October 2011, and while we believe CEO Tim Cook is a more-than-capable leader, Apple runs the risk that its unique culture and sense of innovation may diminish over time.

## Management & Stewardship

We view Apple as a good steward of shareholder capital. Arthur Levinson, former chairman and CEO of Genentech, is chairman of Apple's board of directors. Tim Cook became CEO in August 2011 after cofounder, longtime CEO, and visionary Steve Jobs stepped down from the CEO role before passing away in October 2011. Cook was considered to be Jobs' right-hand man and served in various operations roles with Apple before becoming COO in 2005. We believe Jobs' passing was a blow to the firm, as he was a one-of-a-kind leader and creative mind. We're comfortable with Apple's level of technological innovation over the past couple of years after Jobs' passing. Much of this innovation has come from new software and services within iOS like Apple Pay, rather than brand-new smash-hit products. That said, we still have high hopes that the Apple Watch will deliver incremental earnings growth to Apple, and the firm's ability to execute and deliver another premium product will likely be viewed by many as a sign that Tim Cook's Apple can, or cannot, deliver successful new products over time. Although Apple maintains sterling brand recognition and has hundreds of millions of loyal followers, the company has made a couple of missteps under Cook that, some skeptics would argue, would have never happened under Steve Jobs. Apple executed poorly when it decided to part ways with Google Maps in iOS 6 and launch Apple Maps with a variety of bugs and errors,

leading to a formal apology and the ouster of VP Scott Forstall. Also, Apple was relatively slow to recognize demand for larger-screen iPhones, and although the firm rectified this issue with its iPhone 6 product lineup in late calendar 2014, Samsung and other Android-based competitors had a two-year head start and were able to steal away some iOS customers who sought out a larger-screen device. More recently, Apple launched an iOS 8.0.1 update that was quickly recalled after it rendered some users' phones useless. This misstep could make it more difficult for Apple to quickly push its iOS user base onto the latest version of its operating system in future releases. On the other hand, while many may have questioned Apple's management team about its decision to price the iPhone 5c at \$549, rather than at lower prices that more directly addresses emerging market demand, we tend to approve of Apple's decisions to maintain its premium pricing position. We also applaud Cook's decision to initiate dividend and stock buyback programs, as well as take on debt in order to fund such programs. We recognize that many high-profile investors have called for larger buyback programs, but we think that Apple's current plan of \$90 billion is satisfactory as long as buybacks (and the debt issuances needed to fund these buybacks) are made in a prudent manner. In retrospect, the misstep may have come from not front-loading the buyback program in 2013, when both Apple's share price and interest rates were lower than today. Perhaps more importantly, we think Apple's frugality in terms of acquisitions is quite admirable. Apple's strategy of focusing on smaller, tuck-in deals and developing products in-house, rather than splashy but questionable deals like Microsoft's purchase of Skype or Google's foray into hardware by acquiring Motorola Mobility and Nest, appears to have served investors quite well in recent years. Even Apple's \$3.0 billion acquisition of Beats Music and Beats Electronics represented only a tiny portion of the firm's total cash balance, and we suspect that solid revenue growth and gross margins on headphone hardware sales may have justified the valuation. Apple has also done a good job of attracting top-notch talent to the company in recent months, such as former Burberry CEO Angela Ahrendts to run Apple's retail and online stores, Paul Deneve, the former CEO of Yves Saint Laurent, and Kevin Lynch, former CTO of Adobe. We are comfortable that these hires have strengthened Apple's bench in the unlikely event of Cook departing the company, and each hire likely has aided in Apple's efforts to build and deliver Apple Watch, and perhaps future products as well. All the while, Apple's ongoing operations continue to generate operating margins and cash flow well above its peers in various hardware industries, which bodes well for future free cash flow for investors.

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### Profile

Apple designs consumer electronic devices, including PCs (Mac), tablets (iPad), phones (iPhone), and portable music players (iPod). Apple's products run internally developed software, and this integration of hardware and software often allows the firm to maintain premium pricing for its devices. Apple's products are distributed online as well as through company-owned stores and third-party retailers.

# Google Inc GOOG | ★★★

\$541.83 ↓\$17.25 | -3.09%

Fair Value Estimate	<b>\$545</b>
Consider Buying Price	<b>\$327</b>
Consider Selling Price	<b>\$844.75</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Wide</b>
Stewardship Grade	<b>Standard</b>

10-14-2014 | by Rick Summer

## Analyst Note 10-17-2014

Google's third-quarter results showed robust demand by digital advertisers as the firm's growth continues to outpace the market. Despite higher-than-expected operating expenses (particularly research and development), we did not see anything in the quarter that would cause a structural change in our financial model. We are sticking with our \$545 fair value estimate and our wide moat rating. Overall revenue excluding traffic acquisition costs (excluding payments made to partners) grew 25% versus 2013, a slight deceleration from last quarter but still faster than rates the firm was posting in 2012. Google showed particular strength in its websites segment (which includes the core search business and YouTube, among other owned and operated websites), posting 23% growth, faster than our estimate for overall market growth in the midteens. We are modeling for continued deceleration as the industry and company go through a normal maturation cycle. On the expense side, several items led to a dramatic uptick in costs, although we expect revenue growth to outpace these expenses in the coming quarters. In particular, management pointed to a third-quarter hiring cycle for new college graduates as well as annual equity compensations "refreshes" driving research and development to 16.1% of quarterly revenue, a 210-basis-point increase from the prior quarter and a 260-basis-point increase over 2013. The company remains in a heavy investment period, investing beyond its core business in areas such as cloud computing, YouTube, and a recently relaunched Google Express same-day delivery service.

## The Thesis 10-14-2014

With a dominant Internet search product as its foundation, Google has built an impressive portfolio that individuals use frequently, beyond search. These new products allow advertisers to reach out to potential customers multiple times, in multiple ways. As consumers use multiple devices in a post-PC world, these changing behaviors shine a light on other successful products Google has built in order to keep a hold on users and provide a greater benefit to advertisers. Google's mobile operating system and browser help to unify users' experience as they move from one device to another. The firm's success in products such as Gmail, the Chrome browser, and Google Maps provides a cohesive experience for users and helps Google show more relevant ads. Our general thesis for the online media sector assumes that digital ad spending will continue to consolidate around companies with unique assets and reach, such as Google and Facebook. A strong secular growth trend for online advertising is core to our thesis. The market for Internet search advertising is still growing in the double digits, while display advertising is growing thanks to newer innovations tying display ads to specific actions, including clicks, leads, and customers. Faster-growing geographies such as Asia are propping up overall growth rates even as pockets of economic weakness hit various regions. As the pre-eminent leader in search, Google maintains more than 60% of worldwide market share; no other competitor has even 10%. We believe the company's early technical advantages attracted users who now use it habitually, creating a switching cost based on familiarity with the engine. Although we expect small movements in market

share, we believe Google's dominance will persist and not lose more than 3-5 points of share. Investors should be aware that new businesses and products are unlikely to be as profitable as the desktop search market. As Google will be forced to share payments with other players in the value chain, such as content owners, application developers, and handset makers, profit growth may ultimately lag revenue growth over the long run.

## Valuation

We have increased our fair value estimate to \$545 per share from \$520 to account for cash earned and modestly higher growth in nonadvertising segments, particularly enterprise cloud computing. Our fair value represents a 2014 adjusted price/earnings multiple of 20 and an enterprise value/EBITDA multiple of 15.6. We forecast very modest operating margin improvements from a 2012 trough. We forecast revenue to grow more than 12% annually during the next five years, slightly ahead of the growth rate for the overall online ad industry. Google reports its business in three market segments: Google websites, Google Network websites, and other. Revenue driven by Google websites include its search engine and Web properties such as YouTube and Google Finance. Although we expect minor short-term loss of market share in search, we believe that improvements in monetization (the conversion of a search to a paid click on an advertisement) and overall market growth will help drive revenue. Additionally, with additional investment in display revenue technology and content on YouTube, we have modeled Google websites to grow more than 13% per year. We also expect uplift from mobile search to support strong revenue growth in this core business. Excluding YouTube, search is the most significant cash generator and highest-margin business for Google. We are more conservative in our view of revenue coming from Google Network. Google Network represents revenue earned by the placement of ads on partner websites. We anticipate this growth will be greater than the market, growing in the midteens annually through 2016. As operating expenses have continued to climb, we are becoming more watchful of the firm's limited potential for operating leverage as it enters new businesses. While we believe Google could easily drive operating margins substantially above 40%, it would have to ratchet down its investment in research and development and its data centers to achieve these targets in the short term. It would also need to share less revenue with its partners, which we believe could disrupt the company's advertising ecosystem. We expect long-term operating margins to reach the mid-20s, as the revenue mix continues to move away from desktop search, its most profitable segment. Because Google is heavily investing in new markets, we still expect free cash flow to be depressed over the next few years.

## Risk

Although we believe Internet search is habitual, explicit switching costs are relatively low. Fickle consumers may move to a competitor that is able to establish a stronger brand or a more useful experience. Google is investing in new businesses where it is less competitive, which may lead to a deterioration in its operating margin and return on capital. Advertisers may find new ways to reach their target audience in a cost-effective manner, like Facebook. Finally, competition in technology is fierce, and employee retention may become more difficult and cause an increase in operating costs.

## Management & Stewardship

Cofounder Larry Page was named CEO in April 2011, taking over from Eric Schmidt, who had been CEO since 2001. Schmidt's tenure saw Google define its business model, become a public company, and stay at the forefront of the Internet advertising industry as the largest company by revenue and enterprise value. Schmidt retains his position as chairman of the board and has a more active role in lobbying Washington. The company essentially has been managed by a three-person team of Schmidt, Page, and cofounder Sergey Brin. The company's equity has a dual-class structure that concentrates the voting power in the hands of these three executives, who hold two thirds of the voting rights. They also have a significant economic interest in the firm at more than 15%, which helps to align the interests of management with the shareholders. We are comfortable with management at the firm, but employee

retention will be a continual challenge for Google. Page's style and efforts will not mirror Schmidt's and may cause some short-term disruption. In fact, the senior vice president of product management resigned the week that Page's new title became official. Although we don't view the move as emblematic of any looming management issues, we would not be surprised to see other similar moves, as competition for personnel is ruthless in the technology sector. Generally, we are encouraged by management's long-term focus on capital allocation, although the lack of transparency around milestones for new projects presents an analytic challenge. We are encouraged that past acquisitions including DoubleClick, Android, and YouTube are bearing fruit and deepening the company's moat. Additionally, the management has been pruning products that have not been hitting internal success metrics--a positive development, in our view. The company reached an agreement to sell Motorola's home business to Arris, another positive development, as we did not believe the segment generated excess returns and it also had no strategic benefit.

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**Profile**

Google manages an Internet search engine that generates revenue when users click or view advertising related to their searches. This activity generates more than 80% of the company's revenue. The remaining revenue comes from advertising that Google places on other companies' websites and relatively smaller initiatives, such as hosted enterprise products including email and office productivity applications.



# Vanguard Small-Cap ETF VB | ★★★★★

\$116.85 ↑\$1.22 | 1.06%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$117.02000</b>
Fair Value Estimate	<b>\$</b>
Consider Buying Price	<b>\$</b>
Consider Selling Price	<b>\$</b>
ETF Expected Return	<b>10.15%</b>
ETF Hurdle Rate	<b>13.73%</b>
ETF Expected Excess Return	<b>-3.58%</b>
Morningstar Coverage	<b>18.13% of assets</b>
	<b>169 of 1496 Holdings</b>
Stock Quality (as % of assets)	<b>1.40% Wide Moat</b>
	<b>10.87% Narrow Moat</b>
	<b>5.75% No Moat</b>
Fair Value Uncertainty	<b>High</b>

10-29-2014 | by Michael Rawson, CFA

## The Thesis 10-29-2014

### Suitability

Vanguard Small Cap ETF VB provides low-cost exposure to U.S. small-cap stocks and is a suitable core holding as a supplement to U.S. large- and mid-cap equity funds. Its constituent companies are widely diversified across both sectors and the value-growth spectrum. This fund is particularly well-suited for those seeking to precisely control their market-cap exposure. It is designed to fit with Vanguard Mega Cap ETF MGC and Vanguard Mid-Cap ETF VO in order to cover the vast majority of the U.S. equity market with minimal holdings overlap. However, the index that this fund tracks only represents about 13% of the U.S. equity market. Consequently, this fund should represent a similar percentage of the U.S. equity portion of a passive investor's portfolio.

U.S. small caps have historically provided some diversification benefits. The small-cap Russell 2000 Index was 0.92 correlated with the S&P 500 over the past 10 years. That said, small-cap stocks tend to be riskier as they exhibit greater sensitivity to the business cycle and typically lack sustainable competitive advantages. Thus, their earnings are more volatile and their stocks prices tend to fall farther during tough economic environments, but they may grow faster during economic expansions. Over the past 10 years, the standard deviation of monthly returns of the Russell 2000 Index was 20%, more than 5 percentage points greater than that of large-cap equities, as represented by the S&P 500.

For passive investors, holding a broad or total stock market fund is a more tax-efficient way to obtain small-cap exposure than holding separate funds to cover each size segment because a total stock market fund requires lower turnover. Consequently, it may be more efficient for investors to get the bulk of their exposure to small-cap stocks through a total market fund and then use a smaller position in a small-cap fund for tactical purposes.

### Fundamental View

Small-cap stocks have earned a return premium of about 2% over large-cap stocks since 1926. However, this premium has become smaller in recent decades. From December 1978 through October 2014, the large-cap Russell 1000 slightly outpaced the small-cap Russell 2000 Index. The small-cap premium can also vary drastically over time. For example, during the entire decade of the 1990s, small-cap stocks underperformed large caps by 3% per year.

While small-cap premium may be unreliable, it has been positive over the past 15 years, as small-cap stocks have been on a tear since the bursting of the tech bubble. This stretch of outperformance has caused small caps to look expensive relative to large caps. Back in the tech bubble of the late 1990s, large caps traded at a premium relative to small caps. But this situation has reversed, and small caps now command a premium valuation. For example, in the year 2000, large-cap stocks in the S&P 500 traded at a price/projected earnings ratio of around 27 compared with 14 for the small-cap stocks in the Russell 2000 Index. Currently, large caps trade at a price/projected earnings ratio of around 17, while small caps trade at a multiple of about 19 times prospective earnings.

In addition to being more expensive, smaller-cap stocks often lack economic moats, or sustainable competitive advantages. Consequently, they tend to be less profitable and less resilient in the face of economic turbulence. Stocks in the large-cap S&P 500 generated a return on invested capital of 15% over the past year, while the corresponding figure for those in the Russell 2000 Index was only 2%. Rich valuations and pronounced vulnerability to rocky economic conditions are good reasons to not give an overweighting to small caps at this time. These stocks make up a small portion of the U.S. equity market.

## Fees & Alternatives

At a mere 0.09% per year, this is one of the lowest-cost ways to get exposure to small-cap stocks. Historically, the fund has done a good job of tracking its index. Over the trailing 12 months through September 2014, the fund lagged its index by less than its expense ratio.

### Alternatives

This is our favorite small-cap ETF, but there are a number of alternatives that may be more appropriate for institutional traders or those who prefer to stick with another index family. While Vanguard's may be one of the cheapest, iShares Russell 2000 IWM is the most liquid option in this category. It trades \$4 billion a day on average, compared with the \$42 million traded in VB. But IWM is higher-cost at 0.20%, and with a broader list of 2,000 holdings, it includes volatile micro-caps. iShares Core S&P Small-Cap ETF IJR has a 0.14% expense ratio and pairs well with S&P 500 and S&P MidCap 400 index funds. Schwab U.S. Small Cap ETF SCHA charges just 0.08% and tracks the Dow Jones U.S. Small Cap Total Stock Market Index, which covers 1,750 stocks. Vanguard also manages small-cap ETFs following the Russell (Vanguard Russell 2000 Index ETF VTWO) and S&P small-cap indexes (Vanguard S&P Small-Cap 600 Index ETF VI00). However, these ETFs do not have large trading volume or assets under management.

Investors looking even further down the market-cap ladder at micro-caps and willing to take on the extra risk and higher expense may want to consider iShares Russell Microcap Index IWC. This ETF holds only the smallest public companies traded on U.S. exchanges. This approach, however, results in higher volatility and an expense ratio of 0.60%. Those just looking for a complement to a large-cap U.S. stock holding might consider Vanguard Extended Market Index ETF VXF, which costs a mere 0.10% and is designed to track all stocks traded on U.S. exchanges except for those in the S&P 500.

## Portfolio Construction

Vanguard Small Cap ETF switched its benchmark from the MSCI US Small Cap 1750 Index to the CRSP US Small Cap Index. The switch was driven by Vanguard's long-term goal of minimizing costs. CRSP defines small caps as the 13% of the equity market between the 85th and 98th percentile of size. This methodology currently results in about 1,463 constituent stocks in the CRSP US Small Cap Index. Because this index pulls in a handful of mid-cap names and fewer micro-cap names than the Russell 2000 Index, its average market cap is commensurately higher, clocking in at \$2.7 billion compared with \$1.4 billion for the Russell 2000. The CRSP benchmark doesn't employ many fundamental screens, so it lacks the slight quality tilt of the S&P SmallCap 600 Index. For example, the CRSP index has 30% of its value in stocks with negative retained earnings, compared with 18% for the S&P SmallCap 600. The exchange-traded fund follows a full replication strategy, holding virtually all of the stocks in the index at nearly precise index weightings. Compared with large-cap

funds, small-cap indexes typically have more real estate and industrial sector exposure but less exposure to energy and consumer staples stocks. The fund's dividend yield is lower relative to a large-cap fund because many small-cap companies do not pay a dividend.



# Technology Select Sector SPDR® ETF

XLK | ★★★★★

\$42.49 ↑\$1.95 | 4.81%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$42.1700</b>
Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
ETF Expected Return	<b>6.82%</b>
ETF Hurdle Rate	<b>15.71%</b>
ETF Expected Excess Return	<b>-8.89%</b>
Morningstar Coverage	<b>99.02% of assets</b>
	<b>68 of 72 Holdings</b>
Stock Quality (as % of assets)	<b>50.60% Wide Moat</b>
	<b>45.10% Narrow Moat</b>
	<b>3.19% No Moat</b>
Fair Value Uncertainty	<b>High</b>

09-11-2014 | by Robert Goldsborough

## The Thesis 09-11-2014

### Suitability

Technology Select Sector SPDR XLK offers investors broad exposure to the technology sector. As a sector-specific exchange-traded fund, XLK should be viewed as a tactical investment, suitable only for the satellite portion of a diversified portfolio. XLK holds large-cap names, so it is not suited for investors looking for exposure to more-speculative small- and mid-cap tech firms. This fund is very top-heavy; the top-10 holdings account for 58.5% of the portfolio. And XLK has a very high-quality portfolio: Wide-moat and narrow-moat firms account for about 51% and 44% of assets, respectively. In other words, Morningstar's equity analysts believe that 95% of XLK's portfolio is invested in firms that have sustainable competitive advantages.

Sector SPDR ETFs are very high-quality because they draw from the S&P 500 Index and have a very large-cap tilt.

Even large-cap technology firms are more volatile than the broader market. That said, this ETF has had a volatility of return of 16.8% over the past decade. That's certainly higher than the S&P 500 Index's volatility of return of 14.7%, but it still is relatively low and speaks to the stability offered by some of these large-cap tech behemoths.

### Fundamental View

The single largest dynamic affecting the U.S. tech sector right now is the ongoing shift toward mobile computing and the growth in cloud computing. Mobile and cloud computing are truly a disruptive force in the tech sector. As users shift to mobile devices, PC sales continue to fall. Global PC shipments dropped by 10% in 2013, with the multiyear declines in developed markets now being accompanied by moderate declines in emerging markets. Despite declines in PC sales, the total number of devices sold actually is expected to rise meaningfully in the years to come, as consumers and businesses adapt to smartphones and tablets. In fact, our analysts project that in 2017, some 2.6 billion-plus computing devices will ship--more than twice the total number of devices that shipped in 2012.

Across the U.S. tech sector, firms have been reshaping their portfolios for this ongoing transition. Microsoft MSFT recently acquired Nokia's NOK handset business and has developed the Windows Phone operating system, while Intel INTC

has been investing heavily in producing microprocessors optimized for mobile devices. Apple AAPL long has led the marketplace with its iPhone and iPad, continually gaining share from struggling competitors. And Google GOOG long has had a dominant position in Internet search but has been very successful at aggressively investing in its Android operating system for smartphones and tablets and providing it free of any license fees, which means that having Google software on the device helps to ensure that when users search, they use Google. Enterprise hardware suppliers have been reshaping their businesses as well.

Despite strong valuations in the U.S. tech sector, the merger and acquisition market in the tech arena remains healthy. Investors should expect to see continued M&A activity from firms still looking to round out their portfolios, particularly in key strategic areas of tech such as mobile and cloud-based computing. The multiples of acquisition targets have risen as well, so investors should be on the lookout for the possibility of tech firms overpaying for external growth. In most cases, buyers appear to be justifying paying steep multiples by citing some combination of cost and operational synergies and forecasts of aggressive growth expectations.

Broadly, we have confidence in tech firms' positioning for growth in the medium term. Tech stocks generally are pro-cyclical in their performance, and as the economy strengthens in the short and medium term, tech firms in general should do well. The Gartner Group forecasts that tech spending will grow 3.1% in 2014 to \$3.8 trillion. As large tech players manage and reshape their businesses to adapt to secular declines in PC demand, we expect that they will continue to find ways to benefit from smartphone and tablet growth. To be sure, not all tech players will be winners in a world dominated by mobile computing and cloud computing. For instance, we view cloud computing as a moderate threat to all IT infrastructure suppliers, as cloud service providers are technically savvy customers. That means that as enterprises migrate their infrastructure to these service providers, infrastructure suppliers' pricing power likely will decrease.

Apple makes up 15.5% of XLK's assets, making it far and away this fund's largest holding. Apple has rebounded in 2014 after a turbulent 2013. The company has benefited from strong earnings reports that have beaten expectations and been driven by solid iPhone unit sales in both developed markets and in China. Also driving the runup, Morningstar's equity analysts believe, was tremendous anticipation for iPhone 6s and the iWatch wearable device. As a result, Apple is keeping loyal customers in developed markets but is picking up millions of first-time iOS device buyers in China as well. Despite some concerns earlier in the year about little iPhone growth despite a new partnership with China Mobile CHL, the partnership clearly is a success thus far. iPad sales continue to decline significantly, but there are much lower gross margins on tablets than on iPhones, and a shift toward "phablets" and away from iPad Minis could be good news for Apple. Near-term headwinds remain a stronger U.S. dollar, a rapidly declining iPod market, concerns around iCloud security, heightened phablet competition from Samsung's Galaxy Note Edge, greater revenue deferrals on new product sales, and differences in the timing of iPhone and iPad launches in China. Still and all, Morningstar's equity analysts' long-term view of Apple's fundamentals remains unchanged.

## Fees & Alternatives

This ETF carries a 0.16% expense ratio, which is cheap relative to similar technology funds but slightly higher than Vanguard Information Technology ETF's VGT 0.14% fee.

### Alternatives

Investors seeking exposure to the tech sector can consider Vanguard Information Technology ETF VGT and iShares US Technology IYW, which carry expense ratios of 0.14% and 0.43%, respectively. These funds and XLK are almost perfectly correlated but do have small portfolio differences. In addition to information technology companies, the Vanguard ETF--like the Tech SPDR -- has a 7.5% allocation to IT services companies like Visa V and Accenture ACN. The Tech SPDR has an 11% allocation to telecom services companies such as AT&T. The iShares fund does not hold any telecom services or IT services companies and therefore can be considered the pure-play broad technology ETF.

A recently launched and very inexpensive option is Fidelity MSCI Information Technology ETF FTEC, which charges 0.12%. However, FTEC has minimal assets and

is thinly traded. FTEC tracks a slightly different index from Vanguard Information Technology ETF; FTEC tracks the MSCI USA IMI Information Technology Index, while VGT tracks the MSCI US Investable Market Information Technology 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FTEC commission-free, although they are subject to a short-term trading fee by Fidelity.

The tech-heavy PowerShares QQQ QQQ (0.20% expense ratio) is also a suitable alternative as it has had a near-perfect (98%) positive correlation with XLK over the past 10 years, thanks to its 59% exposure to the tech sector.

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### **Portfolio Construction**

This fund is one of nine Select Sector SPDRs. It tracks the technology sector of the S&P 500 Index and holds 71 companies. XLK's holdings are based on a modified market-cap-weighting methodology, and the top-10 holdings account for a very significant 58.5% of the total portfolio. The largest subsector weightings are computers and peripherals (21%), software (17%), IT services (15.5%), Internet software and services (15%), and telecom services (11%). The average market cap of XLK's holdings is \$126 billion.

# Panera Bread Co Inc PNRA | ★★★

\$167.40 ↑\$5.76 | 3.56%

Fair Value Estimate	<b>\$178</b>
Consider Buying Price	<b>\$124.6</b>
Consider Selling Price	<b>\$240.3</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>None</b>
Stewardship Grade	<b>Standard</b>

11-06-2014 | by R.J. Hottovy

## The Thesis 11-06-2014

Accelerating restaurant transaction trends give us greater conviction that "Panera 2.0" customer experience investments--additional peak-hour throughput capacity, more assessable menu price points, new marketing tactics, and digital ordering--have reinforced the brand intangible asset underpinning our positive moat trend. We're also optimistic about Panera's new growth avenues such as delivery and catering hubs, consumer packaged goods, and usage of mobile devices and other digital technology to engage with consumers and improve store-level operations, all of which are poised to become more meaningful cash-flow contributors. The costs associated with these investments are expected to weigh on profitability through 2015. However, as comparable transaction trends continue to improve over the next year as customer experience investments wind down, we believe Panera's longer-term margin opportunities will become more apparent. Certainly, a more competitive fast-casual restaurant landscape provides potential risks to our assumptions, but we believe these transformation efforts will spur greater unit-level productivity (where Panera is already among industry leaders with \$2.5 million in average unit volumes) while enhancing its operating leverage, better positioning Panera to compete with existing and emergent rivals. Panera generated systemwide sales of \$4.3 billion in 2013, representing 12% of the \$35 billion domestic fast-casual industry and more than half of the \$8 billion domestic fast-casual bakery-cafe category. We expect fast-casual restaurants--which offer higher-quality ingredients than quick-service chains but at lower average prices than casual dining restaurants--to grow nearly 10% during the next few years because of a compelling consumer value proposition and strong unit economics (lower real estate and labor costs than casual dining operators). This exceeds our low-single-digit growth forecast for the restaurant industry, implying market-share gains for Panera. Based on consumers' acceptance of the brand and real estate availability, we believe Panera can add 1,200 new locations the next 10 years, implying 3,000 locations by the end of 2023.

## Valuation

Our fair value estimate is \$178 per share, which implies 23 times our 2015 EPS estimate, an enterprise value that is 10 times our 2015 EBITDA estimate, and a free cash flow yield of about 3% following a reduction in the company's current investment cycle. For 2014, our model is aligned with the high end of management guidance calling for 1.0%-1.5% same-store sales growth at company-owned locations, and assumes 210 basis points of operating margin contraction to just under 11% (compared with management's forecast of 200-225 basis points of contraction) and EPS of \$6.65 (which includes buybacks and compares with current guidance calling for \$6.60-\$6.70). Looking ahead to 2015, we expect same-store sales to improve to 3% as Panera increasingly gains traction with restaurant productivity efforts such as peak-hour throughput investments, higher-ticket signature items, meal upgrade programs, catering, and customer loyalty program engagement. We also expect investments behind these initiatives to taper down during the back half of the year, but still result in a 50-basis-point decrease in

operating margins for the full year to around 10.5%. Looking beyond 2015, however, we anticipate more sustainable top-line growth and meaningful improvement in operating margins. From 2016 through 2023, our model assumes Panera will open 120-130 units per year (representing mid-single-digit annual unit growth) and deliver low- to mid-single-digit comps (even in light increased fast-casual competition), resulting in roughly 9% average annual revenue growth. These assumptions imply there will be 3,000 Panera locations by 2023. During that same time horizon, we expect restaurant-level margins to grow to 23% range (compared with 19.6% in 2013) with operating margins expanding to around 17% driven by higher-margin menu additions (including a mix shift to the breakfast daypart), increased fixed-cost leverage, a vertically integrated supply chain, and incremental contribution from catering and delivery operations. For 2014, management is projecting capital expenditures of \$225 million-\$250 million (9%-10% of revenue), but we expect this pace to moderate over the next 10 years (with approximately 4%-5% of revenue being an appropriate normalized run rate for capital expenditures over a longer horizon).

## Risk

The company faces increased competition on several fronts. Some quick-service restaurant chains are upgrading their menus and decor, while many casual dining firms have become more focused on enhancing their value proposition. Additionally, with retail landlords looking for tenants for unoccupied real estate and restaurant operators finding themselves with easier access to capital in recent months, we believe new fast-casual restaurant concepts will set aggressive growth targets in the years to come. This includes an emergent group of more upscale fast-casual players such as LYFE Kitchen, Mendocino Farms, Piada, and others that could target Panera's more affluent customer base. If its brand appeal isn't as wide as we believe, Panera could face market saturation sooner than anticipated. Demographic shifts, an increasing number of meals prepared at home, and ongoing consumer spending headwinds could damp top-line results. Food, labor, energy, and occupancy cost volatility could disrupt quarter-to-quarter results.

## Management & Stewardship

Founder Ron Shaich, who came out of retirement in March 2012, resumed the role of sole CEO when former co-CEO Bill Moreton transitioned to executive vice chairman in August 2013. Generally speaking, we do not expect any disruptions under this leadership arrangement and we believe Panera's strategic planning and corporate oversight functions are on solid footing. Shaich earned \$2.7 million in fiscal 2013 (a base salary of \$793,500, stock awards worth an estimated \$600,000, and nonequity incentive plan compensation of \$672,000), which strikes us reasonable relative to industry peers. As of the most recent proxy statement, Shaich owned 4.8% of Panera's Class A shares and 84.2% of its Class B shares (representing 11.8% of the combined voting power), which is sufficient to align his interests with common shareholders, in our view. Although we hold the executive management team in high regard, we believe corporate stewardship could be improved by the elimination of measures to limit the powers of outside shareholders, including the dual-class structure, staggered board elections, and other takeover defenses. Still, with a strong track record of capital allocation including making acquisitions at reasonable prices (traditionally between 5 and 6 times trailing EBITDA) and prudent share repurchase activity, we've assigned Panera a Standard stewardship rating.

## Profile

Panera Bread is the largest player in the almost \$8 billion-plus fast-casual bakery-cafe restaurant category. The company owns and franchises bakery-cafes under the Panera Bread, Saint Louis Bread Co., and Paradise Bakery brands, specializing in baked goods, sandwiches, soups, salads, and custom-roasted coffees. Locations are primarily in suburban strip malls and regional malls across the United States. As of September 2014, the firm had more than 1,840 bakery-cafes, including 900 company-owned and 940 franchised locations.

# Twitter Inc TWTR | ★★★

\$41.74 ↑\$0.27 | 0.65%

Fair Value Estimate	<b>\$39</b>
Consider Buying Price	<b>\$23.4</b>
Consider Selling Price	<b>\$60.45</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

07-30-2014 | by Rick Summer

## Analyst Note 10-28-2014

Twitter's third-quarter results and updated guidance are in line with our full-year forecast, and the company's investments in advertising products are continuing to drive increased revenue on a per user basis. Although user growth has slowed, we believe the uniqueness of Twitter's real-time content platform and mobile advertising growth support our valuation and investment thesis. We are maintaining our narrow moat rating and \$39 fair value estimate based on the revision to our model. Although the stock has come down toward our fair value estimate, we would encourage investors to wait for a margin of safety before investing. Advertising revenue grew 109% and total revenue grew 114%, outpacing growth in monthly average users of 23% to 284 million as improved pricing driven by new advertising products proved successful. Management increased full-year guidance to \$1.365 billion-\$1.465 billion, very modestly ahead of our prior forecast, while MAU growth continues to be within our expectations. Still, we note the slowdown in user growth and highlight our belief that Twitter will eventually reach 1 billion users over the next decade. However, because the firm can only monetize these users on line, the current deceleration in user growth may lead to negative sentiment in the stock.

## The Thesis 07-30-2014

Twitter and its users benefit from the network effects typical of a broad content distribution platform. The company counts 271 million monthly active users, an impressive number for a media platform that has captured both attention and budgets from advertisers. Engagement with the Twitter platform is naturally social, reinforcing the desire to share and react to information in real time. The company would argue that it is the largest "real-time" social network in the world, and we would agree. There are many self-selected groups within Twitter, connected by interests. Users may follow celebrities (for example, One Direction and LeBron James), work interests (for example, human capital), and local interests (for example, Chicago events or breaking news). Each user's experience is highly personalized, based on how users create their networks, interact with the content, and post their own content. Twitter is building a unique and proprietary customer data set. In our view, the most important growth levers for Twitter are market share, users, and time spent. Perhaps the most important aspect supporting our positive view on growth is the complementary nature of Twitter to traditional content and media. This will allow Twitter to more cheaply acquire content that flows through its media platform. Still, growth in users has been slowing. Furthermore, the company is competing for advertising dollars with juggernauts such as Facebook and Google. Last, as advertisers may struggle to measure the success of ad campaigns, the company may struggle to attract new ad dollars. Still, we believe the marketing data that Twitter is gathering through the proprietary interest graph will piggyback on the momentum created by Facebook. As advertisers have continued shifting spending to online media, large tranches have remained offline--particularly in TV advertising--because of traditional considerations, including brand-building objectives and broad reach.

## Valuation

For our valuation, we take a weighted average of our base-case, bull-case, and bear-case scenarios. Based on this weighted average, we are increasing our fair value estimate to \$39 per share from \$29 to account for a significantly higher bull case and modestly higher base case, driven by acceleration in monthly average users and higher ad revenue per user metrics. In our base-case scenario, several growth levers contribute to revenue and cash flow growth, and although the firm achieves meaningful growth in users, Twitter's network reaches about half of Facebook's user base. In this model, MAUs grow at a 21% compound annual growth rate through 2022. Additionally, ad revenue per user grows at a 22% CAGR to nearly \$13. We also consider different usage levels within the user base. In the base case, heavy users contribute \$19 per year and casual users contribute only \$4 per year. Total company revenue reaches \$13 billion in 2022, while operating margins reach 28%. Returns on invested capital are approximately 20% at the end of our forecast period. Based on our 10-year discounted cash flow model, this scenario yields a \$30 fair value estimate.

## Risk

The biggest risk to our investment thesis is that the growth potential has saturated, and Twitter never grows into the mainstream Internet population. As a niche product, advertisers are unlikely to dedicate a large percentage of their advertising budgets to the platform. Additionally, the company must successfully launch new advertising products in order to increase ad revenue per user, translating into top-line sales and bottom-line cash flows. Ultimately, the operating model has not been proved, so our operating margin assumptions may prove unattainable as well.

## Management & Stewardship

Dick Costolo has served as CEO since October 2010, having worked at the firm since 2009. Before joining Twitter, Costolo ran several startup technology companies, including a company that was sold to Google, where he then worked for a couple of years. The management team consists of several nonfounders, including Mike Gupta (formerly of Zynga and Yahoo) as CFO and Adam Bain (from News Corporation) as president of global revenue. This management team has been credited with improving the infrastructure and technology powering the Twitter application, as well as delivering new advertising products and scaling revenue growth. We believe its interests are aligned with shareholders', although we acknowledge that Twitter's limited operating history and lack of history as a public company provide little evidence. Still, we are encouraged that, unlike other high-profile initial public offerings, this company has not used a dual-class structure for its common shares. Investors should be aware that venture capital firms will own roughly 46% of the outstanding shares, and their objectives may be more short-term than other shareholders'. We would expect most of those shares to be sold into the open market some time after the lockup period expires (180 days after the company begins trading).

## Profile

Twitter is an Internet platform that individuals and companies use to post short messages (a maximum of 140 characters) that are publicly visible. The company counts more than 271 million monthly active users. Individuals tend to self-organize based on topics of interest (for example, finance or sports) and form a loose social network. Advertising generates nearly 90% of revenue. The service is mostly known for its real-time content.



# Twenty-First Century Fox Inc FOX |



\$35.36 ↑\$2.19 | 6.60%

Fair Value Estimate	<b>\$37</b>
Consider Buying Price	<b>\$25.9</b>
Consider Selling Price	<b>\$49.95</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Wide</b>
Stewardship Grade	<b>Standard</b>

11-21-2014 | by Neil Macker

## The Thesis 11-21-2014

21st Century Fox possesses a vast array of media enterprises worldwide. We believe the company enjoys strong competitive advantages based on its worldwide cable networks, along with its film and television studios. The filmed entertainment segment generates a number of hit television programs and movies annually. 20th Century Fox owns both robust film franchises and a strong television production studio, both of which are important given our premise that the value of quality content will increase. Its studios currently produce 70% of the prime-time slate on Fox and the majority of the original programming on its cable channels, while also creating programs for other networks such as Modern Family on ABC. The critical acclaim for the studio's content, along with its willingness to place shows on the right outlet, creates a virtuous cycle which retains the creators of the studio's hit shows and attracts new creators to the platform. Consumers still consume news and sports programming in real time, not time-shifted on a DVR--a trend that advertisers value. Fox News remains the market leader in news and its recent growth has turned it into one of the 10 most-watched cable channels. As distributors cannot afford to blackout popular channels, we expect Fox to leverage this position into earning higher affiliate fees over the next several years. The Fox broadcast network provides the company with an important platform for showcasing content as broadcasters are the only outlet to reach almost all 116 million households in the U.S. The network holds the rights for the NFL, college football, MLB, and other sports. We believe that the combination of original programming and exclusive sports rights will allow FOX to sharply increase its revenue from retransmission fees and reverse compensation in the near future. Fox also has a large international cable channel segment with over 300 channels reaching 1.4 billion households. Pay-television penetration remains below 50% in many emerging countries. While penetration in these countries may never approach the 90% level of the U.S., we believe that it will continue to expand over the near future.

## Valuation

Our \$37 fair value estimate for 21st Century Fox implies a 20.6 price/earnings ratio on our fiscal 2015 adjusted EPS estimate. We forecast total revenue to increase at an average annual clip of 7.7% from fiscal 2014 through 2018. We expect average annual growth of 9.5% at the cable networks, fueled by affiliate fee increases in the U.S. and growth internationally where we expect pay-TV penetration to improve. We forecast 2.0% average annual growth for the filmed entertainment studio and 4.0% growth for the television segment. We expect overall operating margins to expand to 21.3% in fiscal 2018 from 17.6% in fiscal 2014 as the higher-margin cable networks business continues to become a larger portion of the firm's overall operating profit. Note that our current fair value estimate retains the impact from the direct broadcast satellite segment. Fox recently announced the sale of the segment to BSKyB (also controlled by the Murdoch family). Sky Italia will be sold for \$3.51 billion after the

transfer of its stake in the National Geographic channel back to 21st Century Fox. BSKyB will also pay GBP 2.9 billion or EUR 6.75 (\$9.08) per share for Fox's 57% stake in Sky Deutschland. The deal provides 21st Century Fox with cash for an improved bid on Time Warner. The sale is subject to shareholder and regulatory approvals. We are waiting for the deal to close before removing the segment from our forecasts. Our fair value estimate does not include any impact from a potential merger with Time Warner. On July 16, Time Warner disclosed that its board rejected an unsolicited stock and cash bid from Fox. The bid was reportedly for 1.531 FOXA shares and \$32.42 in cash per TWX share, valuing Time Warner at \$80 billion, or \$85 per share at the time of the offer. While Time Warner reportedly is not engaging with Fox, Murdoch has generally gotten his target even after being rebuffed the first time. We expect Fox to up its bid for Time Warner given the recent BSKyB transaction.

## Risk

The new business models proliferating throughout the media sector could diminish Fox's revenue growth or profitability. Viewership of its programs could fall below expectations, and advertisers could pull back on their spending, both of which could drag on advertising sales growth. The cost of sports rights may continue to skyrocket, putting pressure on margins. The company may overpay if Murdoch raises the bid for Time Warner.

## Management & Stewardship

Fox's stewardship of shareholder capital is standard, which we base on the long corporate history of News Corp. before the spin-off. Chairman and CEO Rupert Murdoch began in 1952 with his family's small newspaper firm in Australia, which he then built into one of the largest global media conglomerates. Murdoch controls roughly 40% of the voting power in Fox despite only having a 14% economic interest in the company. Murdoch's past successes include starting the Fox broadcast network and Fox News Channel in the U.S. Murdoch's recent moves reinforce our belief that he wants his family to remain in charge when he eventually retires. His younger son James was recently promoted to co-COO of FOX and placed in charge of the Fox Networks Group, in addition to his prior responsibility of running the direct-broadcast satellite TV segment. James Murdoch will continue to report to president and COO Chase Carey and to serve as his right-hand man. Most observers believe that James is being groomed to eventually fill the CEO role. However, we believe Carey remains next in line for the CEO spot if it becomes available in the next five years, as he is more prepared than James. We are confident that the company would be in solid hands if Carey stepped into the CEO role. Carey previously served a six-year stint as CEO of DirecTV and served as COO of News Corp from 1996 to 2002. In the past, Fox has implemented shareholder-unfriendly provisions such as the introduction of a poison pill and a staggered board of directors.

## Profile

21st Century Fox is a media conglomerate with a wide range of assets: a film studio, which creates television programs and movies; broadcast television, including the Fox broadcast network and local TV stations in the U.S.; cable networks, which comprise over 300 channels around the world; and direct-broadcast satellite TV in the form of SKY, a satellite pay-tv provider in Europe.

# Kroger Co KR |

\$59.84 ↑\$4.13 | 7.41%

Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
Fair Value Uncertainty	---
Economic Moat	None
Stewardship Grade	Exemplary

08-11-2014 | by Ken Perkins

## Analyst Note 12-04-2014

Kroger reported another quarter of very strong results, and we are placing our fair value estimate under review to reassess our assumptions, including those relating to our cost of capital estimate; we are likely to increase our \$37 fair value estimate by 15%-20%. That said, we think the current market price (\$60) suggests that Kroger can sustain identical-store sales growth above its long-term guidance (2.5%-3.5%) and expand operating margins over the next decade; this scenario is possible, but we believe that buying at these levels leaves little margin of error. Although we do not assign Kroger a moat, given the low customer switching costs inherent to the food retail space, we continue to believe that it remains the strongest traditional grocer in the industry. After reporting its 44th consecutive quarter of positive identical-store sales growth (up 2.8%) and strong margins, Kroger increased its fiscal 2014 guidance for identical-store sales (expected to increase 5% in the fourth quarter) and earnings per share. We believe this increased guidance is achievable, as third-quarter identical-store sales growth remained positive in all departments, private-label penetration increased (now 27.3% of units sold and 25.8% of dollar sales), and results at recently acquired Harris Teeter continued to be strong. Fiscal 2015 guidance (earnings growth at the low end of the long-term guidance range of 8%-11%) was slightly below our expectation, in part because this year's outperformance has been driven by above-average fuel margins. Kroger's FIFO gross margin was roughly flat (down 2 basis points) at 21.2%, but underlying business trends remain very strong, and Kroger was able to leverage and expand FIFO operating margin, which increased 9 basis points in the quarter. We expect that fuel margins will normalize next year, which will weigh on growth, but we think Kroger can sustain an operating margin just below 3% over the long term.

## The Thesis 08-11-2014

Of the traditional U.S. grocers, Kroger is best positioned to handle competitive pressures from nontraditional grocers, in our view. Switching costs are virtually nonexistent in the grocery industry, and price competition has become even fiercer over the past few years due to expanded food offerings at firms such as Wal-Mart, Target, and Costco. These firms use food as a loss leader to drive traffic into stores, which makes it very difficult for traditional grocers, which generate profits from food sales, to maintain price parity while preserving margins. Despite these pressures, we believe Kroger has been more competitive than its traditional grocer peers. With over 2,600 store locations and nearly \$100 billion in sales, Kroger has established scale that allows it to negotiate volume discounts with suppliers and better leverage fixed costs to compete with large rivals. In addition, Kroger partners with consumer analytics firm Dunnhumby to offer personalized promotions for customers possessing the firm's loyalty card. Kroger has also been successful at pushing its private-label products (penetration more than 25%, versus the national average of about 20%), which typically carry higher margins. Kroger manufactures 40% of these company-branded products, giving the firm more control over its supply chain and allowing it to capture all profits from producing and selling these goods. Finally, almost 50% of

Kroger's locations have gasoline offerings, which allow the company to weaken the threat posed by rivals' attempts to lure traffic by offering gasoline. We believe the combination of these factors has allowed Kroger to invest enough in price to remain competitive relative to large multinationals.

## Valuation

We are raising our fair value estimate for Kroger to \$37 per share, up from \$35 per share, primarily to reflect adjustments for the time value of money. Our base-case fair value reflects square footage growth of about 1% annually over the next decade, and identical-store sales growth of around 3.5% over the next five years and near 3% (the middle of management's 2.5%-3.5% long-term target) over the latter stages of our explicit forecast period. These forecasts reflect modest traffic growth and pricing in line with inflation. Our updated fair value estimate also incorporates Kroger's recent acquisition of Harris Teeter, which should add about 4% to total sales and generate cost synergies of \$45 million-\$50 million, a relatively immaterial amount relative to pro forma combined sales of more than \$100 billion. We expect Kroger will reinvest productivity improvements into gross margin, which we forecast to average between 20% and 21% over the next five years (versus a three-year historical average of 20.7%). Similarly, we believe Kroger will reinvest cost SG&A cost savings into pricing to remain competitive, although we think the company could benefit modestly from fixed-cost leverage. We forecast operating margins to average just under 3% over the next decade, in line with (adjusted) historical figures. We incorporate Kroger's underfunded pension plan into our fair value estimate; the underfunded pension plan negatively affects our fair value estimate by approximately 5%-10%. Despite our positive relative stance on Kroger, we believe the market price leaves little margin for error. Increasing competition could pressure top-line growth and/or margins, but the current market price implies that Kroger can sustain 3.5% identical-store sales growth, the high end of management's range, over the long term while generating 3.1% average operating margins (versus a 2.6% average margin over the past six years and a 2.8% margin in fiscal 2013). We think these results are achievable, but given competitive threats, we believe the probability of both occurring simultaneously is lower than the market projects.

## Risk

We assign medium uncertainty risk rating to Kroger. The defensive nature of the grocery industry, as well as Kroger's past ability to endure the endless competitive incursion from nontraditional food retailers, has allowed the company to generate steady cash flows. Still, the company's top-line growth could be challenged during recessionary economic environments, particularly if the pricing environment becomes ultra-competitive as firms seek to drive traffic. In addition, input cost volatility could challenge Kroger's profitability in any given period. Kroger manufactures myriad products ranging from milk to dog food, giving the firm diversified commodity exposure but also leaving it vulnerable to aggregate commodity inflation.

## Management & Stewardship

We assign Kroger an Exemplary stewardship rating, as the company has consistently driven identical-store-sales growth, taken market share, and generated excess returns on capital despite intensifying competition. We believe Kroger's strong stewardship reflects an experienced management team and a performance-based compensation structure that encourages management to make decisions that are aligned with the long-term interests of shareholders. David Dillon, who was named CEO of Kroger in 2003 and chairman of the board in 2004, stepped down as CEO at the beginning of January 2014. Dillon is still chairman of the board but was succeeded by current CEO Rodney McMullin, who has worked in several roles in his 30-plus years at the firm. We think McMullin has ample experience to draw from while making strategic decisions to confront new competition. Historically, only about 10% of CEO pay was awarded in the form of base salary, while about 30% was from pension and deferred compensation and the remainder was awarded in the form of stock/option awards. To determine annual cash-based compensation, the company measures performance relative to annual targets for identical-store sales (excluding fuel) and EBITDA (excluding fuel). The annual bonus also takes into

account performance regarding strategic efforts (undisclosed due to competitive reasons) and fuel operations. Long-term compensation is determined based upon three-year performance relative to stated goals. Kroger measures operating costs (as a percentage of sales), associate engagement levels, and return on invested capital to determine long-term compensation.

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**Profile**

Kroger is one of the largest retailers in the U.S. The company operates more than 2,600 supermarkets, 750 convenience stores, and 325 jewelry stores in 31 states. In addition to its namesake banner, Kroger operates several other banners, including Ralphs, Fred Meyer, King Soopers, Fry's, and Food 4 Less. Kroger also acquired Harris Teeter Supermarkets, Inc. at the end of fiscal 2013.

# E I du Pont de Nemours & Company DD



\$71.40 ↑\$2.25 | 3.25%

Fair Value Estimate	<b>\$64</b>
Consider Buying Price	<b>\$38.4</b>
Consider Selling Price	<b>\$99.2</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

10-28-2014 | by Jeffrey Stafford

## The Thesis 10-28-2014

DuPont is known by most as a chemical producer, but over the years, its portfolio has shifted markedly to agriculture, nutrition, and biosciences. The agriculture business now makes up about a third of DuPont's operating profit. The company brings new genetically modified seed and crop chemical offerings to market in a similar way to a pharmaceutical company researching and developing new drugs. Competition in the seed industry is stiff, with wide-moat Monsanto leading the pack. That said, we believe DuPont has done work over the past several years to close the gap with Monsanto, particularly in corn seeds. Further, DuPont has bested Monsanto in recent years in marketing and distribution with its more regional strategy and direct-selling model. We think both companies will benefit from the demands that an increasing (and richer) population will put on farmers to grow more food. Another important cog in the portfolio is the performance chemical business, which houses titanium dioxide production. TiO<sub>2</sub> is a commodity product used mainly as a hiding agent in paints. While the commodity nature of TiO<sub>2</sub> can lead to wild swings in profits for performance chemicals, DuPont benefits from its position on the low end of the cost curve. The company employs a unique chloride-ilmenite process that allows it to convert low-grade feedstock to high-grade TiO<sub>2</sub> at a lower cost than competitors. DuPont maintained double-digit operating profitability during the recession, while competitors struggled to stay in business. Recently, DuPont announced plans to spin off the performance chemicals business. DuPont's advanced materials business has produced some noteworthy (and high-profit) products over the years. The company invented products such as Lycra and Kevlar, which have wide applications in textiles and safety equipment. Teflon, which is used in nonstick cookware, and Tyvek, broadly used in construction materials, also demonstrate DuPont's successful product development and innovation. The company has a solid record of innovation, and we think it will be able to replace earnings from older products as they fall out of favor or are leapfrogged by new technologies.

## Valuation

Our fair value estimate for DuPont is \$64 per share. Our fair value estimate, based on a discounted cash flow model, implies a price/earnings ratio of 16 times and an enterprise value/EBITDA ratio of roughly 9 times based on 2014 estimates. Although there will be near-term pressure on seed sales as some North American farmers switch from corn to soybeans, we expect the agriculture segment will drive growth for the company over the long run, as it introduces new products and grabs its fair share of emerging-market growth, particularly in South America. The acquired Danisco businesses also stick out as potential growth drivers. We think total company margins will improve going forward, but we believe the company may fall short of its target of 12% average growth in earnings per share. We use a 12% cost of equity in our model.

## Risk

DuPont faces stiff competition in the seed and crop chemical markets. There is no guarantee the firm's investments in researching and developing the next generation of biotech traits will bear fruit, and the company could fall further behind Monsanto. Other risks in agriculture include the possibility that weeds and bugs could develop resistance to the firm's products, rendering the company's technology useless. Additionally, consumer sentiment could turn against bioengineered crops in the United States and South America, similar to conditions currently prevailing in Europe. The failure to develop new products could also hit the firm's other businesses. Further, as a manufacturer, increased costs for raw materials and energy could negatively affect margins if the company is not able to pass on higher costs to customers. In DuPont's commodity products, including titanium dioxide, oversupply could drive prices lower and damage profitability. Our uncertainty rating for DuPont is high. The company's ability to continue developing innovative products is uncertain, especially given tough competition. DuPont still produces a number of commodity products whose demand fluctuates with economic conditions. On the upside, growth could accelerate if the company develops a new blockbuster product in agriculture or materials.

## Management & Stewardship

We think DuPont's stewardship of shareholder capital is Standard. Ellen Kullman became chairman and CEO in 2009, having been with the company for decades and working in various divisions. She replaced CEO Charles Holliday, who had served the company since 1998. Kullman has put her stamp on shaping DuPont with the acquisition of Danisco, the divestiture of the performance coating business, and now the upcoming spin-off of the firm's performance chemicals unit. We like the efforts to push DuPont's portfolio toward more specialized businesses. DuPont purchased Danisco in 2011 for \$5.8 billion, valuing the company at nearly 14 times EBITDA. While the valuation was considered rich for the industry, DuPont probably paid a high enough price to ensure a successful closing of the deal without landing in a potentially costly bidding war (Royal DSM later announced that it had accumulated Danisco's shares at the same time). Subsequently, DuPont sold its performance coating business--which focused on auto OEM, refinishing, and industrial coatings--for \$4.9 billion and \$250 million in other postemployment benefits liability assumption. The sale price valued the segment at roughly 14 times trailing 12-month EBITDA, which we think is an attractive valuation for DuPont's shareholders. The performance chemicals spin-off will focus DuPont on higher-growth industries, but we liked the competitive advantages the unit holds in the production of titanium dioxide. We expect the company will return cash to shareholders through an active stock-repurchase program and steady dividend stream.

## Profile

DuPont is a diversified chemical company operating in more than 80 countries. Its massive portfolio includes agriculture, feed and nutrition, electronics and communication, construction and transportation, and safety and protection. DuPont has tried to move into more specialized products, and acquiring Danisco plays to this strategy. The company has also increased its research into genetically modified seed technologies, making it one of the most prominent global seed providers.



# Enterprise Products Partners LP EPD |



\$37.34 ↑\$0.44 | 1.19%

Fair Value Estimate	<b>\$43</b>
Consider Buying Price	<b>\$30.1</b>
Consider Selling Price	<b>\$58.05</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Wide</b>
Stewardship Grade	<b>Exemplary</b>

08-22-2014 | by Jason Stevens

## Analyst Note 12-01-2014

Midstream stocks are selling off in the aftermath of OPEC's Thanksgiving Day decision to maintain existing production quotas, dashing the market's hope that OPEC would step in and remove excess crude oil supply from the market. By our estimates, oil markets are oversupplied by roughly 1 million barrels a day, which may increase into early 2015 absent a production response. We think that the market's reaction is overdone, particularly if you consider that 1 million to 2 million barrels a day of excess supply is equivalent to 1.1% to 2.2% of daily consumption, and depletion alone removes roughly 4% of total production each year. Moreover, the supply surge from U.S. shale oil has been well anticipated by markets, leaving us to wonder what has changed fundamentally in the market's awareness that has dropped the energy sector as a whole by 20% since September 1. We suggest investors pay attention to oil demand, as any further weakness could spark another leg down in oil markets. That said, over the medium term we'd expect lower crude prices to stimulate demand, supporting our expectation of higher prices in the future. We think the market reaction among midstream firms in particular has been overdone. While some U.S. MLPs do have modest direct crude oil or natural gas liquids price exposure, the vast majority of cash flows are linked to long-term, fee-based contracts, supporting relatively stable cash flows despite market tumult. Moreover, midstream firms create value by building new assets. Despite low oil prices, we continue to see robust project pipelines from firms in our coverage. We view the current pullback in stock prices as a good opportunity to buy quality franchises at a discount. Wide moat MLPs such as ONEOK Partners, Williams Partners, and Enterprise Products Partners look compelling currently, as do large-cap midstream corporations Spectra Energy, Williams, and Enbridge.

## The Thesis 08-22-2014

We continue to believe that Enterprise is one of the best-run pipeline partnerships we cover, with best-in-class assets that are positioned to monetize every link of the midstream value chain. Enterprise gathers natural gas from wellheads from the Rockies to offshore Gulf of Mexico, operates gas processing plants that separate natural gas liquids from the gas stream, transports crude oil, natural gas, and NGLs on dedicated pipelines to market hubs, provides storage and fractionation for NGLs, and markets natural gas and NGLs to the petrochemical industry. In good times, Enterprise earns economic rents on each link of the midstream chain, and in bad times, it can optimize flows across its system. We think the breadth of Enterprise's asset base fosters attractive and often unique internal growth projects. In addition to infill projects, such as processing plant expansions and connecting gathering systems to new wells as they are completed, Enterprise is large enough to undertake significant new projects, such as the ATEX Express and looping Seaway pipeline, both of which entered service this year. ATEX moves ethane from the Marcellus Shale to Enterprise's NGL and petrochemicals complex along the Gulf Coast, and the

Seaway expansion doubles the partnership's capacity to move crude oil to the Gulf. Increasingly, Enterprise is leveraging its Gulf assets to provide export services for ethane and LPG. While Enterprise's assets span the midstream energy space, its dominance in NGLs is most pronounced. No other midstream firm has integrated its gas and NGL operations as closely, and none can approach its downstream integration into refiners and the petrochemicals industry. We think this integration positions the partnership for stable base cash flows and provides a tremendous platform for growth. Enterprise is constructing three more NGL fractionators, expanding its propylene splitter, and has announced a propane dehydrogenation unit, all of which will provide attractive fee-based earnings and create a demand pull along the partnership's gas and NGL pipelines and facilities.

## Valuation

Our fair value estimate is \$43 per limited partner unit, adjusting for the 2:1 stock split effective on Aug. 21. We now forecast gross operating margin, Enterprise's preferred metric, to grow roughly 11% a year through 2018 and model \$5.4 billion for 2014. This should translate to 2014 EBITDA of \$5.2 billion, by our modeling, and distributable cash flow of \$3.9 billion. We raised our distribution growth expectation to 9% a year and model a full-year 2014 distribution of \$1.46 per unit (on a paid, not declared, basis). Our valuation is based on the average of two methods. Our standard discounted cash flow model values Enterprise at \$43, while a distribution discount model also values the partnership at \$43 per unit. Our fair value estimate implies that Enterprise is worth roughly 17.8 times our 2014 EBITDA estimate and a forward yield of 3.4%.

## Risk

Access to capital markets is a concern that could make it more difficult, or more expensive, to fund growth plans, though Enterprise demonstrated its ability to secure financing in late 2008 while markets were otherwise seized. Enterprise also faces the risk of extreme swings in natural gas and NGL prices, particularly with regard to the margins earned from processing natural gas. Increasing competition among pipeline companies could cut into Enterprise's margins. A portion of the company's assets are susceptible to disruption from hurricanes. Evolving industry regulation, spills, fires, and explosions are always risks.

## Management & Stewardship

We think Enterprise demonstrates exemplary stewardship. Enterprise has outperformed all other MLPs--and most asset classes, for that matter--over the past three, five, and 10 years and consistently generated returns in excess of capital costs. The 2010 decision to merge Enterprise and its general partner, Enterprise GP Holdings, eliminated incentive distributions and effectively reduced Enterprise's cost of raising new equity; we think this was a savvy move that will pay dividends (or, in this case, distributions) to limited partners for years. We are also fans of the partnership's conservative distribution management, which focuses on steady distribution increases while retaining cash to reinvest in the business, and has allowed Enterprise to reduce its cash capital costs, thereby preserving a greater share of future cash flows for current unitholders. We think Enterprise is very well managed, and we're pleased with the leadership of CEO Michael Creel and COO Jim Teague, an industry veteran with deep experience with NGLs and petrochemicals. Enterprise's board chairman is Randa Duncan Williams, daughter of the partnership's late founder Dan Duncan. We also think that Enterprise boasts admirable bench strength; business heads have deep expertise in midstream businesses and bring a wealth of experience to the table. From a stewardship perspective, the only strike against the firm is its structure; as a master limited partnership, common unitholders have very limited rights and virtually no say in the management of the firm. As long as Enterprise continues to generate superior returns and sustainable cash flow growth, we're OK with that.

## Profile

Enterprise Products Partners is a master limited partnership that transports and

processes natural gas, natural gas liquids, crude oil, refined products and petrochemicals. It is one of the largest midstream energy companies, with operations serving most producing regions in the Lower 48. Enterprise is particularly dominant in NGLs and is one of the few MLPs that provides midstream services across the full value chain. As a partnership, Enterprise pays no corporate income tax; its tax burden flows through to individual stockholders.

# Walt Disney Co DIS | ★★★

\$92.51 ↑\$1.13 | 1.24%

Fair Value Estimate	<b>\$95</b>
Consider Buying Price	<b>\$66.5</b>
Consider Selling Price	<b>\$128.25</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Wide</b>
Stewardship Grade	<b>Standard</b>

11-21-2014 | by Neil Macker

## The Thesis 11-21-2014

While Disney is a media conglomerate, we view the company as two distinct yet complementary businesses: media networks, which include ESPN and ABC, and Disney-branded businesses, including parks, filmed entertainment, and consumer products. The crown jewel of Disney's media networks segment is ESPN. It dominates domestic sports television with its 24-hour programming on ESPN, ESPN2, and its growing sister networks. ESPN has exclusive rights within both NFL and college football, the premier sports programming rights in the United States. ESPN profits from the highest affiliate fees per subscriber of any cable channel, and generates revenue from advertisers interested in reaching adult males ages 18-49, a key advertising demographic that watches less scripted television than other groups. This dual income stream is a significant advantage not shared by the broadcast networks, which rely primarily on ad revenue. The Disney Channel also benefits from attractive economics, as its programming consists of internally generated hits with Disney's vast library of feature films and animated characters. Disney's other components rely on the world-class Disney brand, sought after by children and trusted by parents. Over the past decade, Disney has demonstrated its ability to monetize its characters and franchises across multiple platforms--movies, home video sales, merchandising, and theme parks. The stable of animated franchises will continue to grow as more popular movies get released by the animated studio and Pixar, which has already generated hits such as "Toy Story," "Cars," and most recently, "Frozen." Similar to the animated franchises, Disney arranged the Marvel universe to create a series of interconnected films and product tie-ins. With the acquisition of Lucasfilm, Disney appears to be positioning the Star Wars franchise in the same manner. Disney's theme parks and resorts are almost impossible to replicate, especially considering the tie-ins with its other business lines.

## Valuation

Our fair value estimate of \$95 per share implies price/earnings of approximately 19 times our fiscal 2015 earnings per share forecast. We expect average annual top-line growth of about 6.0% through fiscal 2019. We forecast 4.5% average annual sales growth from the media networks (6.4% for affiliate fees and 3.6% for advertising), driven by growth at ESPN and Disney Channel. We project 7.9% average annual sales growth during the next five years for parks and resorts. The investments that required heavy capital expenditures over the past few years are bearing fruit now including the launch of Shanghai Disneyland in fiscal 2016. We forecast operating margins for the segment to 20% by fiscal 2019. We have modeled 4.5% average annual growth for the filmed entertainment segment due to the addition of the Star Wars movies and the growth in television, subscription VOD and other distribution outlets. We estimate 5.6% annual growth for consumer products, which should benefit from continued global growth of key Disney brands, which now include Star Wars. We believe the interactive segment will continue to generate slightly positive operating income over the next five years, albeit a very small piece of the overall Disney pie. We project Disney's overall operating margin will improve to 24.1% in fiscal 2019

from 23.6% in fiscal 2014. We think this profit expansion is achievable, as the highest-margin segment, cable networks, will grow at a faster rate than the overall firm.

## Risk

Disney's results could suffer if the company cannot adapt to the changing media landscape. Basic pay-television service rates have continued to increase, which could cause consumers to cancel their subscriptions or reduce their level of service. ESPN garners the highest affiliate fees of any basic cable channel and a decrease in pay-TV penetration would slow down revenue growth. The cost of sports rights may continue to skyrocket, putting pressure on margins. The company's ad-supported broadcast networks, along with the theme parks and consumer products, will suffer if the economy weakens. Making movies is a hit-or-miss business, which could result in big swings in profitability for the filmed entertainment segment.

## Management & Stewardship

While we place Disney's stewardship of shareholder capital as Standard, we believe that the current management team is in the upper end of the tier of its direct peers. Chairman and CEO Bob Iger began his tenure as CEO in October 2005 and chairman in March 2012 and is currently scheduled to serve until June 2016. While Tom Staggs, former CFO and now head of the parks business, and Jay Rasulo, current CFO and former head of the parks business, are still viewed as the top candidates to replace Iger, we believe that Iger could decide to extend his retirement date once again. Under Iger, Disney has embraced new technology and also reinvigorated its commitment to high-quality content. He understood the importance of animation to the company early in his tenure, purchasing Pixar, the computer animation studio, in 2006, and then resurrecting Disney's own studio. Beyond Pixar, the company has made significant investment in new technology/distribution including buying Club Penguin (an MMO for children) and Maker Studios (a network of YouTube channels). Iger also purchased two major content creators (Marvel and Lucasfilm) that expanded the demographics served by the company.

## Profile

Walt Disney owns the rights to some of the most globally recognized characters, from Mickey Mouse to Buzz Lightyear to Thor to Luke Skywalker. These characters and others are featured in several theme parks that Disney owns or licenses around the world. Disney makes live-action and animated films under several labels, including Pixar, Marvel, and Lucasfilm. Disney also operates media networks including ESPN, ABC, and Disney Channel, and several television production studios.

# Alerian MLP ETF AMLP | ★★

\$18.10 ↓\$0.48 | -2.58%

ETF Valuation Rating (as of 12-04-2014)	<b>Overvalued</b>
ETF Market Price (as of 12-04-2014)	<b>\$18.0400</b>
Fair Value Estimate	<b>\$19.14</b>
Consider Buying Price	<b>\$13.00</b>
Consider Selling Price	<b>\$17.43</b>
ETF Expected Return	<b>12.09%</b>
ETF Hurdle Rate	<b>22.24%</b>
ETF Expected Excess Return	<b>-10.15%</b>
Morningstar Coverage	<b>46.80% of assets</b>
	<b>10 of 26 Holdings</b>
Stock Quality (as % of assets)	<b>36.29% Wide Moat</b>
	<b>10.43% Narrow Moat</b>
	<b>% No Moat</b>
Fair Value Uncertainty	<b>Medium</b>

07-17-2014 | by Abby Woodham

## The Thesis 07-17-2014

### Suitability

Investors drawn to the yield and solid fundamentals of master limited partnerships have made ALPS Alerian MLP ETF one of the fastest-growing exchange-traded products today. MLP funds like AMLP attempt to address the complications of direct MLP ownership--namely, that K-1 forms must be filed in every state each MLP operates in. AMLP offers advantages such as simplified tax filing (investors receive a standard 1099 form) and diversification. Because it is an exchange-traded fund, AMLP also passes the deferred tax treatment of MLP distributions on to its investors. However, the fund has major drawbacks. AMLP is a corporation, not a fund registered under the Investment Company Act of 1940 like most ETFs, because open-end funds are not allowed to have more than 25% of their portfolio in MLPs. The fund is liable for taxes at the corporate level, which has caused AMLP to lag its underlying index by a staggering 8% annualized since inception through the end of February. With other investment options available that track the performance of MLPs much more closely, investors should carefully examine whether AMLP's costs are worth its benefits.

AMLP's lagging performance is a byproduct of how tax-deferred MLP distributions behave in a fund structure. MLP unitholders are liable for taxes on their share of the partnership's income every year. Fortunately, the bulk of MLP distributions is considered a return of capital because MLPs use depreciation to offset their net income. Instead being an immediately taxable event, distributions reduce an investor's cost basis. Taxes are only owed on the distributions when an investor sells their units. At that point, the IRS views the income as recapture of past depreciation deductions, and investors will owe their ordinary income rate. Functionally, the investor is able to defer paying taxes on distributions until they sell their shares. Because AMLP is a corporation, the fund itself has to pay corporate taxes on the adjusted cost basis when it sells underlying investments or if it ever liquidated. AMLP accrues for this future tax liability in its net asset value, which means AMLP must give up about 38% of its return in every year when the fund's total return is positive. Because MLPs have done so well in recent years, this tax drag caused the fund to significantly lag its benchmark. On the flip side, AMLP will decline less than its ETN competitors in a down period because it can reverse its tax liability reserve.

Fundamental View

Because MLPs must pass through the majority of their taxable income, they need to rely on debt financing for new projects. If interest rates rise again, the cost of capital for MLPs would increase, which could result in lower distributions. MLPs have historically struggled during rising rate markets, but not to the extent of other rate-sensitive investments like REITs or high-yield fixed income. During the bond sell-off of 2013, MLPs dipped but quickly recovered and went on to post strong returns for the year to date through the end of the year and for 2014 through the end of the second quarter.

The major performance drivers for MLPs are growing United States energy production and, to a lesser extent, worldwide energy demand. Higher U.S. production means more volume flowing through pipelines, translating into revenue growth and higher dividends for MLPs. The production outlook continues to be bright: Production grew by 13.9% in 2012 compared with 8% growth in 2011, and the U.S. currently produces more natural gas than any other country in the world. Morningstar's energy analysts predict that natural gas production will increase 4% through 2015. Production is expected to continue to increase into 2020 according to the U.S. Energy Information Administration, particularly from offshore and shale drilling. Worldwide energy consumption, on the other hand, was less encouraging last year. The weak state of the global economy pressured consumption in 2013 and 2012, with worldwide natural gas consumption down in 2013 and only up by 2.2% in both 2011 and 2012. European demand will likely continue to be a demand headwind due to the region's weak macro outlook. U.S. natural gas consumption was up 4.1% in 2012, but oil consumption declined 2.3%.

This fund tracks infrastructure MLPs, which specialize in gathering and processing, petroleum transportation, and natural gas pipelines. Gathering and processing MLPs transport raw gas from the wellhead, process it, and move it to the cross-country pipelines. They often keep the impurities and sell them for additional revenue. Natural gas pipeline MLPs take processed natural gas and transport it through their extensive pipeline systems. They charge fees by volume with long-term contracts, so as long as the gas keeps flowing at increasing volumes, pipeline MLPs will maintain good revenue growth. Petroleum pipelines transport crude oil to the processing plants and then ship the products to consumers. Propane MLPs operate in a similar manner, transporting the product as a liquid. MLPs can engage in other businesses, including coal.

Economic moats are common in the MLP space. The largest MLPs, like Enterprise Products Partners LP EPD, own several businesses to capitalize on their scale and offer start-to-finish services. Federal regulations require new energy projects to undergo a rigorous vetting process, so economically unviable pipelines are rarely built. As a result, most pipelines and processing facilities run by MLPs are local monopolies. Almost 60% of the assets in AMLP's underlying index receive a Wide Morningstar Moat Rating. A remaining 30% receive a Narrow moat rating, and 10% are rated as having no moat.

### Fees & Alternatives

AMLP charges a management fee of 0.85% annually, which is the typical going rate for exchange-traded MLP products. However, because the fund has corporate tax liabilities, its actual gross expense ratio is 8.56%. After taxes, AMLP is one of the most expensive ETPs on the market.

#### Alternatives

Most MLP products are exchange-traded notes, which promise to pay the investor the return of the underlying index less fees. ETNs expose investors to the credit risk of the issuer. We usually advise against ETNs when ETF alternatives are available, but because of AMLP's unusual costs, the ETN structure may make more sense for most MLP fund investors.

JPMorgan Alerian MLP Index ETN AMJ was our pick for investing in MLPs until J.P. Morgan capped creations in June 2012. The decision effectively turned the note into a closed-end product. AMJ struggled from March to September of 2013 to not trade at a premium of 2%-5%. New investors should consider similar MLP exchange-traded products instead of purchasing AMJ at a premium. AMJ charges a 0.85% path-dependent fee.

The closest substitute for AMJ is UBS E-TRACS Alerian MLP Index ETN AMU, which tracks the same index. AMU's 0.80% expense ratio undercuts all of its competitors,

which charge 0.85% or more. AMU was launched a month after AMJ's cap was announced, but it has struggled to attract significant assets and trades on very low volume.

UBS E-TRACS Alerian MLP Infrastructure ETN MLPI has grown significantly since AMJ stopped issuing new shares. MLPI tracks a more-concentrated index of 25 infrastructure MLPs compared with AMJ's 50, and it charges a 0.85% expense ratio.

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### **Portfolio Construction**

AMPL tracks the Alerian MLP Infrastructure Index, which is composed of 25 pipeline and processing MLPs. Owning MLPs outright creates a tax headache: K-1 forms must be filed in every state each MLP operates in. AMLP handles all K-1s instead and sends investors a single 1099, which is much easier to handle. The ETF structure passes the tax deferral benefits of MLPs to holders of AMLP. However, because of legislation forbidding open-end funds from owning more than 25% of their portfolio in MLPs, AMLP is structured as a C-corporation. If an owner holds an MLP for a long enough time that the reduced tax basis reaches zero, any further basis reductions from distributions will be automatically taxed as a long-term capital gain.



# Facebook Inc FB | ★★

\$77.70 ↑\$2.71 | 3.61%

Fair Value Estimate	<b>\$60</b>
Consider Buying Price	<b>\$36</b>
Consider Selling Price	<b>\$93</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Wide</b>
Stewardship Grade	<b>Standard</b>

07-23-2014 | by Rick Summer

## Analyst Note 10-29-2014

Facebook reported strong third-quarter earnings, posting 59% revenue growth and 90% growth in GAAP operating income. The largest social network in the world reaches 1.3 billion monthly active users and 864 million daily active users, and our investment thesis for it remains intact. As we adjust our model to account for higher near-term expenses, our long-term model continues to assume operating margin expansion, and we don't anticipate a material revision to our \$60 fair value estimate. In our view, the stock is overvalued, and we wouldn't recommend allocating new money toward the name at this time. The negative effects of recently closed acquisitions Oculus Rift (a virtual reality company) and WhatsApp (a global messaging company) will amplify operating expenses in 2015 versus this calendar year, according to comments made by management. While we currently model revenue to grow approximately 30% in 2015, expenses are now set to grow 55%-75% (50%-70% non-GAAP). We had not previously expected a dramatic compression of operating margins. Management reiterated its intention to invest in projects that may not contribute significantly to revenue or cash flows for the next five years, and the updated expense guidance supports that vision. In our opinion, if public equity investors have a shorter-term time horizon than management's, the stock is likely to trade below our fair value estimate, creating an attractive entry point for investors. Still, we are focused on near-term milestones such as WhatsApp user growth and revenue contribution for the next several quarters, as we aren't fully convinced of the value some recent acquisitions bring to shareholders.

## The Thesis 07-23-2014

Facebook is building the foundation to revolutionize online advertising. However, the company will need to leverage its proprietary consumer data beyond Facebook as an intermediary to place advertising across the Internet at large. Facebook's massive base and engagement arguably create advertising opportunities that capture reach and target based on specific criteria. Growth in Facebook's user base across geographies has been impressive. Monthly active users exceed 1.3 billion, and the company operates the largest social network on the web. These users are logging into Facebook at least once a month, communicating with friends, posting pictures, and using applications. We believe hundreds of millions of users face switching costs that keep them from leaving Facebook. People are unlikely to leave unless they can take their network of friends, content, and applications with them. The company's growth in mobile usage has been equally impressive, particularly considering that Facebook was very slow to market with a downloadable application. The company's mobile usage is skyrocketing, and there are almost 1 billion mobile users. In fact, there are now more mobile users than desktop users, and revenue from mobile ad products exceed revenue from desktop. After its long delay in building mobile advertising products, we believe the company is a preeminent mobile advertiser. In spite of our bullishness about the company's prospects, the company will need to aggressively grow advertising revenue per user to justify a premium market valuation, in our view. As the company is already the most visited desktop and

mobile site in the world, Facebook will have to find new and innovative ways to continue increasing advertising units and pricing. Ultimately, this growth is not limitless, and we believe any meaningful slowdown will have negative impact on what the stock is worth.

## Valuation

We are increasing our fair value estimate to \$60 per share from \$50 to account for a recent results and an increase in our 2014 forecast for growth and profitability. Our valuation represents a multiple of 40 and 23 times our 2014 adjusted earnings per share and adjusted EBITDA estimates, respectively. In modeling the company, we forecast 10 years of financial statements. Admittedly, there is a great deal of uncertainty about Facebook's ultimate growth trajectory and profit profile, but the exercise is important to us for several reasons. First, we believe the company will reach its structural maturity within 10 years, whereby it has normalized operating margins and cash flow yields. Second, understanding the size of the revenue opportunity at the end of our explicit forecast period helps quantify our level of optimism about the firm's revenue potential. While we would not feel comfortable about our level of precision in forecasting the absolute level of revenue in three years, we do think our 10-year forecast results in a fair representation within a range of possible outcomes. The key value drivers in our model include revenue of \$45 billion in 2021, operating margins normalizing at approximately 42%, and forward returns on invested capital of more than 30%. Facebook's revenue would still be meaningfully lower than Google's, according to our forecasts, but profitability metrics would be similar. We expect Facebook to have to continue investing in sales and marketing, which would drive additional operating expenses. Additionally, the company will have to increase its revenue sharing with third parties for an advertising network, and we would also expect local and payment businesses to have higher-cost structures than the existing business.

## Risk

Although the revenue opportunity for Facebook is large, the company faces several risks that could ultimately prove our investment thesis to be overly optimistic. First, regulators may prevent the company from tracking its users. Significant regulatory action could detract from the value of its advertising platform. Second, excessive advertising or privacy fears could lead to a mass exodus of users. Other social networks (for example, MySpace, owned by News Corporation NWS) have experienced declines. Lastly, if agencies and advertisers experience a permanent lack of visibility into advertiser return on investment, Facebook's advertising opportunity may be significantly constrained.

## Management & Stewardship

Mark Zuckerberg founded Facebook and has held the role of CEO since 2004. He also serves as chairman of the board. Chief operating officer Sheryl Sandberg has worked at Facebook since 2008 after spending more than seven years in an executive-level role at Google GOOG. We have a positive view of the skill set and performance of the management team to date and believe its patience and capital allocation have enabled it to drive profits and competitive advantages. While we expect Facebook to continue to be patient as a young public company, we acknowledge management may feel pressure to pursue revenue growth in areas that may actually weaken the firm's economic moat. The concern about capital allocation becomes even more paramount because Zuckerberg controls about 57% of the voting shares of the company. In 2012, the company acquired Instagram, a social networking site for sharing photos. Although the purchase only represented approximately 1% of the value of Facebook, it has been reported that the deal happened with very little involvement from the board of directors. If Zuckerberg loses discipline in allocating the company's capital, there can be no guarantee that any such mechanism would prevent the company from destroying shareholder value.

## Profile

Facebook's 1.3 billion monthly active users create the world's largest online social

network. More than 800 million people use Facebook daily, spending more time there than any other website, according to most third-party reports. Users go to Facebook to communicate with friends, share news, and play games, providing the company with a treasure trove of information to target online advertising. Currently, the U.S. represents less than 20% of traffic but less than 45% of overall revenue.

# Walgreen Co WAG | ★★

\$68.61 ↑\$4.39 | 6.84%

Fair Value Estimate	<b>\$58</b>
Consider Buying Price	<b>\$40.6</b>
Consider Selling Price	<b>\$78.3</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>None</b>
Stewardship Grade	<b>Standard</b>

11-24-2014 | by Vishnu Lekraj

## The Thesis 11-24-2014

The delivery of pharmaceuticals to consumers encompasses many firms along the supply chain, and Walgreen stands out as a major player. The firm is one of the largest pharmacy retailers in the United States as it processed a little more than 16% of total U.S. prescriptions during its fiscal 2014. Its large network of retail locations spans the continental U.S., which gives Walgreen the ability to reach 75% of the U.S. population, according to its own estimates. However, we believe the firm will face a pressured operating environment. While approximately two thirds of Walgreen's revenue is derived from the sale of prescription drugs, we believe the firm is analogous to a mix of convenience and mass retail store. Management has said it will look to push front-store (nonpharmaceutical) products in order to drive revenue and profits. In our opinion, this demonstrates the weaker position along the pharmaceutical supply chain for Walgreen as it tries to offset a more pressured retail pharmacy operating environment with grocery and convenience goods. This strategy will also put the firm in even more direct competition with the mass grocers and retailers and into sectors where profits and outside returns on invested capital are hard to come by. Walgreen also contends with a pharmaceutical customer base that has enormous pricing power. It derives a significant majority of prescription revenue from third-party payers (employers, insurers, managed-care organizations, government programs) and large pharmacy benefit managers represent most of these customers. Large PBMs are able to aggregate an enormous amount of claim volume and leverage this into powerful pricing negotiating power. This dynamic puts enormous pressure on retail pharmacies, and the ability of these players to push back on pricing demands from customers is a challenge. In the U.S., consumers of prescription drugs typically use only five major intermediaries to adjudicate more than 65% of the total adjusted prescriptions filled annually. This effectively makes two thirds of Walgreen's revenue heavily reliant upon only five major customers, which can lead to enormous pricing pressure.

## Valuation

Our fair value estimate for Walgreen is \$58 per share. The Alliance Boots acquisition will add enormously to Walgreen's top line over the course of 2016, increasing total revenue by approximately 30%. We also believe the firm will be able to produce solid long-term profit enhancement as a result of its partnership with AmerisourceBergen. From our perspective, the recent strategic partnerships Walgreen has closed should allow it to gain greater distribution efficiency and enhanced manufacturer pricing leverage and ultimately lead to increased profitability over our explicit forecast period. We forecast adjusted prescriptions to grow moderately, driven by the firm's continued recovery from its dispute with Express Scripts, shifting U.S. demographics, and increased pharmaceutical usage by health-care benefit payers. Offsetting this dynamic is flat prescription drug pricing as generics become a greater percentage of prescriptions filled and payers look for ways to hold the overall cost of employee benefits in check. We also project the firm's sales from front-store products (nonpharmaceutical goods) to grow in line with

overall U.S. GDP growth. This mix of assumptions gives Walgreen a 11.7% five-year revenue compound annual growth rate and average operating margins of 7.0% that range from 5.7% to 7.8% over our explicit forecast.

## Risk

The main risk facing Walgreen is another contract dispute with a major customer that could cause a contraction in both top- and bottom-line results. With what is effectively an oligopoly, the firm's retail pharmacy operations faces sizable pricing pressure. This variable will be even more heightened given the focus of many drug plan payers on significantly curbing overall plan costs. Additionally, a significant portion of Walgreen's results depends on consumer discretionary spending, which can fluctuate materially during an economic cycle.

## Management & Stewardship

The recent strategic moves made by management have added positively to Walgreen's long-term outlook. After suffering negative results because of a miscalculation during the Express Scripts contract negotiations, management has made a series of partnership moves that have enhanced the firm's long-term operations. Most notably, the firm has begun the process of acquiring Alliance Boots, a major European pharmacy distributor/retailer. This acquisition should enhance the firm's overall retail operations and build more efficiency into its distribution capabilities. Additionally, the firm has effectively increased its manufacturer pricing negotiation power as it can now use the combined demand of both major retailers. The firm also recently announced an alliance with AmerisourceBergen, where the major U.S. pharmaceutical distributor will eventually be the primary supplier of a vast majority of Walgreen drug products. This move again helps to bolster both the distribution efficiency and supplier negotiating leverage for the firm. However, the firm's recent partnership with Express Scripts is perhaps the most important and positive. The decision to allow Express Scripts' mail-order customers the option to pick up their mail-order prescriptions at Walgreen locations is a major positive, in our opinion. This move will allow Walgreen to capture a piece of Express Scripts' mail-order volume and offset CVS Caremark's advantage in this delivery channel. Most important, though, is that we believe this action demonstrates management's ability to turn a negative into a positive. The strained relationship with Express Scripts over retail drug pricing seems to be fading as Walgreen has changed an adversarial relationship into a positive partnership, benefiting shareholders greatly as a result. While the synergy outcomes and ultimate net present values of these projects are still yet to be realized, management's emphasis on vertical integration is directionally correct.

## Profile

Walgreen is the nation's largest retail pharmacy, with about 8,500 drugstores throughout the United States. This large network of stores allows the firm the ability to reach a significant portion of the U.S. population, providing excellent brand recognition. Prescription drugs account for about two thirds of sales, with most of the rest attributable to front-store products such as grocery, health, and beauty items. The firm also operates in-store health clinics.



# Bristol-Myers Squibb Company **BMJ**



**\$59.05** ↑ **\$0.86** | **1.48%**

Fair Value Estimate	<b>\$53</b>
Consider Buying Price	<b>\$37.1</b>
Consider Selling Price	<b>\$71.55</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Wide</b>
Stewardship Grade	<b>Standard</b>

10-02-2014 | by Damien Conover

## Analyst Note 10-30-2014

Bristol reported strong Phase II lung cancer data with Opdivo that reinforce our peak sales estimate of \$10 billion (versus \$5 billion for consensus), so we don't expect any change to our \$53 fair value estimate. Based on the strong stock price movement in reaction to the data, the stock looks slightly overvalued. Nevertheless, the strong clinical data reinforces our wide moat rating for Bristol as Opdivo represents close to 30% of our valuation for the entire company. The Phase II data showed impressive efficacy in line with earlier clinical data. The one-year survival rate in heavily pretreated lung cancer patients was 41% (versus a historical rate of 6%-18%). We expect that this data will lead to the drug's approval in early 2015, which should give Bristol at least a one-year advantage over competition. We expect approval for Merck's competing drug Keytruda in lung cancer in early 2016. While several immuno-oncology drugs (similar mechanisms of action to Opdivo) are in development for many types of cancer, we believe the lung cancer indication represents the largest opportunity. We project the lung cancer market will represent an \$18 billion opportunity by 2022 with immunotherapies claiming the lion's share of the market. Beyond lung cancer, renal cancer (\$2 billion-\$3 billion market) and melanoma (\$2 billion-\$3 billion market) represent the other near-term opportunities for immuno-oncology.

## The Thesis 10-02-2014

Adept at partnerships and acquisitions, Bristol-Myers Squibb has built a strong portfolio of drugs and a robust pipeline. While the company faces significant patent losses that continue through 2017, we expect its next generation of drugs will fill the patent holes over the next decade, supporting its wide moat. Further, by selling off business lines unrelated to its core pharmaceutical strategy, the company has been streamlined to focus primarily on specialty pharmaceuticals. Bristol has created a strong pipeline and brought in partners to share the development costs and diversify the risks of clinical and regulatory failure. We believe the cardiovascular partnership with Pfizer represents one of the most important partnerships, managing the blockbuster potential of Eliquis in atrial fibrillation. While Bristol discovered the drug internally, we like its strategic partnering decisions, as the moves reduce risks and lowers development and marketing costs. Bristol's pipeline becomes even a bigger safety net as the company faces a plethora of patent losses over the next few years. The patent on blockbuster antipsychotic drug Abilify expires in 2015, followed by patent losses on several virology drugs between 2015 and 2017. Within the pipeline, Bristol's astute acquisition of Medarex helps secure Bristol's strong first-mover advantage in cancer immunotherapy, which should yield several major blockbuster compounds. In particular, Bristol's PD-1 cancer drug Opdivo holds the potential to revolutionize cancer treatment and should develop into a multi-billion-dollar opportunity for the company. Bristol is aggressively repositioning itself to grow through the challenging patent losses. The company has shed its diabetes business,

medical imaging group, wound-care division, and nutritional business in an effort to focus on the high-margin specialty drug group. Its more focused operations and increasing cash account also make the company a more attractive acquisition target for a larger pharmaceutical firm.

## Valuation

We are increasing our fair value estimate to \$53 per share from \$49 largely because of increased projections for new immuno-oncology drug Opdivo. Bristol announced pricing for Opdivo in Japan at \$143,000 annually, significantly above our estimated \$80,000 global average price, which led to the increased projections. The strong Japanese pricing of Opdivo in melanoma patients should translate into strong pricing in both the U.S. and Europe in melanoma and other more important indications, such as lung cancer. Generally speaking, Japanese pricing is a slight discount to U.S. pricing and close to European pricing, which means worldwide pricing in developed markets should be close to the Japanese price. Also, since the dosing is the same for Opdivo in melanoma as in lung cancer, we expect a similar price point for Opdivo in the much larger lung cancer market. We continue to view Opdivo as holding the most potential for the firm. Based on strong survival data in an early-stage Opdivo study, we believe the drug and other immunotherapy drugs will take more than half of the lung cancer market by 2022. While the company faces several patent losses over the next few years, we continue to have strong conviction in its pipeline, led by Opdivo, which has potential to significantly alter the treatment paradigm in several major cancer settings (melanoma, lung, renal). We project the drug will reach risk-adjusted peak sales of more than \$10 billion. The recently approved drug Eliquis for cardiovascular disease should develop into a major blockbuster as well. In looking at the whole company, we expect 6% average annual sales growth during the next 10 years. While patent losses will slow the growth of the company over the next two years, new pipeline drugs should position the company for strong growth in 2016. We expect margins to eventually expand, but the high royalty rate paid on Eliquis to Pfizer will weigh on gross margins for the firm.

## Risk

Bristol is increasing its focus on branded drugs by selling off unrelated business lines, which elevates its exposure to patent losses. Further, the increased branded drug focus raises the company's dependence on its pipeline. This will result in higher sales volatility than observed at its more diversified peers. Additionally, the company is exposed to risks facing the entire pharmaceutical group, including generic threats, decreasing pricing power due to managed-care constraints, and product liability cases. From a product-specific standpoint, we believe the company's largest pipeline risk surrounds its immunotherapy drugs, which could develop into major blockbusters or fail to reach the market, depending on clinical data.

## Management & Stewardship

In early 2010, Lamberto Andreotti and Charles Bancroft took over Bristol's top posts, replacing James Cornelius as CEO and Jean-Marc Huet as CFO, respectively. While these appointments didn't signify a major shift in Bristol's strategy, the new leaders have their roots with Bristol and are replacing outsiders (before joining Bristol, Cornelius was the CEO of Guidant and Huet was the CFO at Royal Numico). We don't see any red flags stemming from the management flight; we believe Cornelius' decision to retire was consistent with his age of 66, and Huet's decision to take the CFO post at Unilever placed him at a larger company. Andreotti brings a strong record of management in Bristol's European operations dating back to 1998. Before joining Bristol, he held several positions with Pharmacia (acquired by Pfizer). Bancroft also brings a solid Bristol tenure, as he joined the company in 1984 and has held positions of increasing responsibility in finance. On the stewardship front, we rate current management as standard. Several acquisitions like Medarex have been excellent uses of capital, but other deals like Inhibitex and Amylin may represent overpayments for assets. However, additional time is needed to see how some of these deals will play out before making definitive judgments. Also, on the positive side, Bristol has been aggressively cutting costs to adapt to its scale following patent losses, which we believe will help open up capital for reinvestment in the business.

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**Profile**

Bristol-Myers Squibb discovers, develops, and markets pharmaceuticals for various indications, such as cardiovascular and infectious diseases, cancer, and immune disorders. Unlike some of its more diversified peers, Bristol has exited several nonpharmaceutical businesses to focus on branded drugs.

# Energy Select Sector SPDR® ETF XLE |



\$79.82 ↓\$7.60 | -8.69%

ETF Valuation Rating (as of 12-04-2014)

ETF Market Price (as of 12-04-2014) **\$81.96000**

Fair Value Estimate **\$**

Consider Buying Price **\$**

Consider Selling Price **\$**

ETF Expected Return **18.33%**

ETF Hurdle Rate **15.75%**

ETF Expected Excess Return **2.58%**

Morningstar Coverage **97.98% of assets**

**40 of 45 Holdings**

Stock Quality (as % of assets) **34.34% Wide Moat**

**56.56% Narrow Moat**

**6.91% No Moat**

Fair Value Uncertainty **Medium**

11-25-2014 | by John Gabriel

## The Thesis 11-25-2014

### Suitability

Energy Select Sector SPDR XLE can be used by investors as a tactical satellite holding to achieve broad exposure to the energy sector. The fund offers diverse exposure to the various industries that comprise the sector. Exploration and production firms make up the largest portion of the portfolio at 35% of assets, followed by integrated oil and gas firms (29%), equipment and services companies (18%), refiners (8%), pipelines (8%), and drillers (3%). The fund represents an inexpensive and efficient way to invest in the U.S. energy sector, without assuming too much idiosyncratic risk.

As a market-cap-weighted fund, the fund's portfolio is fairly top-heavy. Vertically integrated supermajors Exxon Mobil XOM and Chevron CVX alone make up nearly 30% of XLE's portfolio. While these two firms represent a large chunk of assets, they operate in a diverse set of businesses across the energy complex. Their operations range from exploration and production all the way down to distribution. This helps damp the supermajors' sensitivity to energy prices but does not eliminate it entirely.

Other segments of the oil patch, such as exploration and production, are much more sensitive to volatile energy prices. Investors should expect the underlying firms' reliance on energy prices to translate into higher volatility for XLE relative to the broader market. For example, the S&P 500 experienced a standard deviation of returns of 15% over the trailing 10 years. Over the same period, the standard deviation of returns for XLE was more than 22%. Geopolitical risks can be a key factor driving volatile energy prices. Current turmoil in the Middle East, speculation about production cuts (or lack thereof) by Saudi Arabia and other OPEC members, as well as surging shale oil volumes out of the United States have all contributed to recent energy price volatility.

Over the years, the diversification potential of XLE seems to have been eroding. Over the trailing 15-year period, XLE has been 65% correlated with the S&P 500. However, over the trailing 10- and five-year periods, its correlation to the S&P 500 has increased to 70% and 86%, respectively. Still, the fund remains an effective tool for investors seeking to have an overweighting to the energy sector within a broadly

diversified portfolio. The energy sector currently makes up about 9% of the S&P 500. Keep in mind that as a U.S. sector fund, XLE does not offer exposure to international supermajors such as BP BP or Royal Dutch Shell RDSA.

### Fundamental View

Integrated oil and gas companies have operations that span the full energy value chain. These companies, which represent about 30% of XLE's assets, explore for and produce oil and gas, transport it, refine or process it, and sell it to end users. The integrated model has historically provided firms like Exxon Mobil and Chevron with competitive advantages. By integrating across the energy value chain, these firms are able to gain much tighter control over the production and sale of oil and gas, and they get to keep profits they would otherwise have paid out to middlemen in the form of economic rents.

In an attempt to secure long-term access to large-scale resources, the large integrated firms are competing for huge new projects and increasingly partnering with foreign national oil companies seeking to exploit government-owned resources. In a world of diminishing investable resources, securing such partnerships is important to help drive growth. This puts added emphasis on firms' technical expertise, ability to execute on time and budget, safety record, and cost of capital. Exploration and production companies, which make up roughly 35% of XLE's portfolio, concentrate their efforts almost exclusively on exploring for, acquiring, and producing oil and natural gas. These firms face myriad risks, including commodity price volatility, exploration risks, operational risks, and political and regulatory scrutiny. Given the intense competition in this segment as well as the difficulty individual firms face in establishing competitive advantages, getting diversified exposure through an ETF like XLE may be appropriate for most investors.

Equipment and services firms, which represent approximately 17% of XLE's assets, provide the expertise necessary to improve oil and gas well economics and boost well productivity. The industry does serve U.S. independent oil and gas firms, but its largest customers tend to be the major international and government-owned oil companies. Demand for services in any given year tends to wax and wane, depending on customer expectations around commodity prices, particularly in North America, where contracts are usually very short.

The cyclical nature of the industry can obscure some of the positive long-term trends, which remain favorable. Oil, in particular, is becoming harder to find and extract. Global oil production has been stagnant since 2005, even after a trillion-dollar investment by the oil and gas industry. The number (and size) of oil discoveries made has been declining for decades. Oil-services firms' expertise is growing increasingly more valuable as the industry seeks to explore and extract oil from ever-more-challenging frontiers in new deep-water and even Arctic efforts. Large efforts are also under way to boost recovery rates from old fields.

Morningstar equity analysts use benchmark oil and gas prices based on Nymex futures contracts in their discounted cash flow models. If those forecasts prove incorrect, their fair value estimates will be off en masse. As of this writing, Morningstar equity analysts estimate that XLE is trading at a 16% discount to its aggregate fair value. Current geopolitical tensions and oversupply concerns could provide an attractive entry opportunity for long-term investors.

### Fees & Alternatives

Select Sector SPDR ETFs are among the cheapest and most-liquid sector funds available. The fund's 0.16% expense ratio is low even by ETF standards. Moreover, its estimated holding cost of 0.17% means the fund has done an excellent job tightly tracking its benchmark. Note the difference between the fund's expense ratio and its estimated holding cost can be explained by the transaction costs associated with its replication strategy.

### Alternatives

Two close alternatives for exposure to the domestic energy sector are Vanguard Energy ETF VDE and Fidelity MSCI Energy ETF FENY, which are slightly cheaper with expense ratios of 0.14% and 0.12%, respectively. The Vanguard and Fidelity funds provide a bit more diversification, with about 160 holdings each, but tend to be just as top-heavy as the SPDR fund. Similar to XLE, approximately 60% of VDE and FENY's assets are invested in the top 10 holdings. The inclusion of smaller energy firms has not resulted in lower volatility, as each of the funds' historical standard

deviation of returns has been nearly identical.

For exposure to the international energy space, investors may also consider iShares Global Energy IXC, which is pricier with annual fees of 0.47%. The fund's global focus does not meaningfully improve the potential diversification benefits and actually increases the fund's already substantial large-cap bias. Oil is a fungible commodity, so global prices tend to be highly correlated. We view international diversification within the energy space to be less beneficial than in other sectors of the market. In fact, XLE has been 98% correlated with IXC over the past 10 years. Moreover, IXC has underperformed its domestic counterparts over the trailing 10-year period with similar levels of volatility. Given that the global iShares fund charges 3 to 4 times as much as the aforementioned alternatives, we would prefer sticking with one of the cheaper domestically focused funds under most scenarios.

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### **Portfolio Construction**

This exchange-traded fund holds 43 oil and gas and energy-services companies included in the S&P 500 Index. These firms make up the energy sector's entire 9% weighting in the S&P 500 Index. The weightings of each stock roughly correspond to each stock's market cap. Thus Exxon Mobil, the largest oil company in the world, makes up roughly 16% of assets, and the top 10 holdings soak up more than 60%. Constituents are leading U.S. companies that meet S&P's profitability criteria. These criteria eliminate non-U.S. oil companies, including Royal Dutch, Total, and BP. Large-cap stocks make up about 84% of the portfolio, with mid-caps representing the remaining 16% of assets. The holdings-weighted average market capitalization of the fund's portfolio is roughly \$63 billion.

# Citigroup Inc C | ★★☆☆

\$53.97 ↑\$0.44 | 0.82%

Fair Value Estimate	<b>\$48</b>
Consider Buying Price	<b>\$28.8</b>
Consider Selling Price	<b>\$74.4</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

07-14-2014 | by Jim Sinegal

## Analyst Note 11-12-2014

We see the coordinated regulatory settlement of charges that bank traders illegally manipulated foreign exchange rates as modestly good news for the six banks involved. The \$4.3 billion of total charges are within expectations and well below our worst fears, and the settlement helps to reduce uncertainty for investors. In the coordinated settlement with the U.K.'s Financial Conduct Authority, the U.S. Commodities and Futures Trading Association, and Switzerland's financial regulatory Finma, total fines paid by RBS, HSBC, Citi, JPMorgan, and UBS each ranged from \$618 million to \$799 million. UBS paid the largest total fine, \$799 million, and Citi paid the largest single fine, \$358 million to the FCA. Later on Nov. 12, the U.S. Office of the Comptroller of the Currency announced total fines of \$950 million for Citi, JPMorgan, and Bank of America. Other banks, including Barclays, Deutsche Bank, Credit Suisse, and Standard Chartered continue to be under investigation on similar charges. We plan to maintain our fair value estimates and moat ratings for all involved banks. We consider the settlements to be further evidence that conduct in large, complex financial-services organizations is difficult to control and that regulatory costs are likely to remain at permanently higher than precrisis levels. We were disappointed to see that the illegal conduct continued until October 2013, several months after the probes began. Moreover, the conduct persisted over six years despite numerous whistleblowers and client complaints at the banks. We think that with the high-stakes compensation systems at global banks, and in their investment banks in particular, it will be difficult for banks to eliminate this type of misconduct.

## The Thesis 07-14-2014

There are plenty of reasons to be wary of Citigroup. Over the past few decades, the bank has teetered on the edge more than once, taking massive losses on emerging-markets loans in the 1980s, commercial real estate in the early 1990s, and subprime-related securities in the 2000s. Citigroup has made progress over the past five years by raising capital, shedding assets, and bulking up its board of directors and management team. However, with operations spanning several continents, the bank in many ways still embodies the "too big to fail" concept. In our view, Citigroup's truly global presence differentiates the bank from nearly all of its peers. With a large portion of revenue coming from Latin America and Asia, the bank is poised to ride the growth of these economies over the coming decade. At the same time, Citigroup is not merely a domestic lender, and it should remain a bank of choice for global corporations thanks to its ability to provide a variety of services across borders. Developing economies offer an attractive combination of high margins and rapid credit growth--especially in comparison with the low rates and declining leverage we expect will persist in the U.S. and other Western economies for the next few years. At the same time, investors should prepare for volatile results out of emerging economies, where governments and economic systems have generally not stood the test of time to the same extent as developed markets. Since its bailout, Citigroup does not appear to be chasing growth at any cost. Instead, management is

attempting to scale back operations and cut expenses--a proven plan for turning around troubled banks. Citigroup is consolidating back-office functions and reducing consumer operations in far-flung geographies like Pakistan and Paraguay and concentrating its branch network in key international markets, including Brazil and Hong Kong. We think investors should view further announcements along these lines with relief rather than disappointment and focus on improvements in the bottom line more so than growth in the top line.

## Valuation

We are boosting our fair value estimate to \$48 from \$45 per share, equivalent to 0.7 times book value per share and 10 times our 2015 earnings per share estimate. In our base-case valuation, we think assets will remain flat during the next five years with the continued runoff of Citi Holdings' assets offset by the growth of loans outside the U.S. We think the net interest margin will improve slowly to approximately 3.0% by 2018 as nonperforming assets fall and interest rates normalize somewhat. We forecast noninterest income to increase by approximately 4% cumulatively during the next five years, as increases in fee-based income are offset by a decline in principal transactions revenue. We expect net charge-offs to slowly decline during our forecast period, averaging 1.8% in the long run. We expect the efficiency ratio to average 61% over the next five years. Our valuation reflects a middling level of profitability, with return on assets reaching 0.9% by the end of our forecast period and return on equity reaching 8%. We assign Citigroup a 12% cost of equity based on the volatility of the company's post-provision revenue, the moderate level of operating leverage inherent to the business, and the bank's high level of financial leverage relative to the rest of our coverage universe. We assume that the company will utilize deferred tax assets over the medium term, and we assume a tax rate averaging 27% over our forecast period.

## Risk

Citigroup's presence in emerging markets is the company's biggest advantage, but it's also the source of the most risk. Rapid credit growth can be highly profitable on the way up, but almost never ends well. Citigroup is banking on the long-run rise of the global consumer, but there are bound to be bumps on the way, leading to volatile financial results. A secondary source of risk is the company's investment bank, a business that we consider to be a perennial source of disappointment for investors.

## Management & Stewardship

We view Citigroup's recent stewardship of shareholder capital as standard. In our view, an analysis of Citigroup's management must start with the board of directors, which has improved dramatically during the past five years. Chairman Michael O'Neill turned around Bank of Hawaii during his time as CEO of the island institution, making shareholders multiples of their initial investment. Board member Robert Joss enjoyed similar success during his time at Westpac. Other members of the board boast experience at premier financial services companies, including American Express, RenaissanceRe, and PIMCO, while others served as regulators. We think the board is well positioned to oversee continued improvements at Citigroup. We also think new CEO Michael Corbat's experience will serve Citigroup shareholders well. In contrast to Vikram Pandit, who brought investment banking and hedge fund experience to the CEO role, Corbat has served in a variety of basic banking roles around the world during his time at Citigroup. We like that he appears to be focused on scaling back the bank's operations, announcing cost cuts and branch closures in his first major move as CEO. However, we think it will take time to change the company's culture, and missteps along the way are inevitable. In our view, management should be evaluated over the near term by its ability to cut expenses and return capital to shareholders. In addition to the amount of capital returned, we're interested to see how management balances dividends and repurchases. While the restoration of the company's dividend is a plus, we would look favorably upon repurchases as well. A substantial buyback program seems a good fit for the earnings volatility possible thanks to Citigroup's investment bank and international consumer book.

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**Profile**

Citigroup is a global financial services company doing business in more than 160 countries and jurisdictions. Citicorp, the company's core business, consists of the global consumer banking segment, which provides basic branch banking around the world, and the institutional clients group, which provides large customers with investment banking, cash management, and various other products and services. Noncore businesses and questionable assets are now part of Citi Holdings.



# Whole Foods Market Inc WFM | ★★★

\$49.03 ↑\$9.70 | 24.66%

Fair Value Estimate	\$45
Consider Buying Price	\$31.5
Consider Selling Price	\$60.75
Fair Value Uncertainty	Medium
Economic Moat	Narrow
Stewardship Grade	Exemplary

11-03-2014 | by Ken Perkins

## Analyst Note 11-06-2014

Whole Foods Market's shares jumped after the company reported better-than-expected fourth-quarter earnings, providing some credence to our view that the market has been pricing overly pessimistic results into the stock. We are maintaining our \$45 fair value estimate, as we don't expect to make a material change to our long-term assumptions, and the time value of money should compensate for fiscal 2015 sales growth guidance that was slightly below our forecasts. While the shares still trade at a slight discount to our fair value estimate after rising from recent lows, we note that increasing competition is still a real threat to long-term growth. Whole Foods is in the early innings of combating its "Whole Paycheck" image, and as a result, we caution against extrapolating one quarter of outperformance into the foreseeable future; we think the risk/reward opportunity would be more attractive with a slightly larger margin of safety. Our narrow moat and stable moat trend ratings are intact, as Whole Foods continues to generate positive traffic and basket growth, take market share, and drive returns on invested capital higher. Comparable-store sales increased 3.1% (traffic up 1.3% and basket size up 1.8%) in the quarter and accelerated to 4.6% (traffic up 2.1% and basket size up 2.5%) in the first month of fiscal 2015, in line with our expectations. Square footage growth was slightly ahead of our expectations, as was new store productivity, which drove top-line outperformance.

## The Thesis 11-03-2014

Whole Foods Market is the largest retailer of natural and organic foods and is also the first Certified Organic grocer in the United States. In many regards, the Whole Foods banner serves as an icon for health and quality, and this brand image allows the company to sell groceries at premium price points, drive private-label penetration higher, and sustain excess returns on capital. With a first-mover advantage in a niche segment of the grocery market, Whole Foods can also leverage its brand equity to deploy capital into highly profitable new stores. As Whole Foods increases its store density across major markets, it also lowers per-unit costs. Whole Foods estimates that annual sales of natural products sold through U.S. retail channels approximate \$80 billion, less than 15% of the roughly \$600 billion U.S. consumers spend on food consumed at home. Whole Foods leads the market segment with more than 350 stores (13 million square feet), and its differentiated value proposition (wide organic product range and customer service) has helped the firm avoid aggressive competition from nascent rivals. Notable competitors are The Fresh Market and Sprouts Farmers Market, both of which operate approximately 150 stores that are smaller (about 20,000 square feet for TFM and 25,000-28,000 square feet for SFM) than the average Whole Foods store (38,000 square feet) and carry fewer stock-keeping units (9,000-10,000 at TFM versus more than 20,000 at Whole Foods). Many other concepts are popping up across the country, and some large grocery store operators are looking to expand organic and natural food offerings. Competitive sourcing could be a challenge in the future if retailer demand for organic and natural foods outpaces supply. Whole Foods makes most of its purchasing decisions on a

regional or national scale to maximize volume discounts. The firm sources nearly one third of its purchases from United Natural Foods Inc., and its distribution agreement with UNFI extends through 2020. Despite this supplier concentration, we think Whole Foods has ample negotiating leverage since its brand equity, and not that of a supplier (and or its products), is the primary traffic driver.

## Valuation

Our fair value estimate is \$45 per share, which implies a forward price/earnings ratio of roughly 26, an enterprise value/EBITDA ratio of approximately 11 times, and a free cash flow yield approximating 3%. The key long-term drivers that determine our fair value estimate are low-double-digit revenue growth and operating margins reaching new historical peaks over the next decade. Whole Foods sees an opportunity to operate at least 1,200 stores in the U.S. alone, nearly triple its current store count. At the firm's current pace of 30-40 new stores additions per year, Whole Foods should be able to increase square footage by 7% annually over the next decade. Based upon the historical relationship between new store openings and comparable store sales growth, we think Whole Foods can generate 5%-6% annual same-store sales growth over the next decade. We anticipate that per-unit costs could decrease as the firm's store density and private-label penetration (Whole Foods' 365 private-label brand) increase, but we assume that the firm reinvests these costs savings into price. That said, we expect that Whole Foods can expand operating margins by leveraging store, general, and administrative expenses, and we forecast operating margins to expand to a peak of more than 7% over the next decade.

## Risk

Whole Foods faces several risks, including the risks of slower organic food consumption growth, aggressive competition from new entrants, traditional grocers, mass merchants, and wholesale clubs, real estate missteps resulting from opening more than 30 new stores per year, real or perceived concerns about product quality, and supply chain disruptions. Another economic slowdown that causes consumers to trade down to lower-priced conventional products could also weigh on Whole Foods' comparable-store sales and profit margins.

## Management & Stewardship

We assign Whole Foods an Exemplary stewardship rating, as we believe management's capital allocation policies have bolstered the firm's economic moat. Whole Foods' returns on invested capital have improved over the past several years, largely because of the firm's ability to expand operating margins. This margin expansion has been driven by a number of factors, including distribution, direct store, and general and administrative expense leverage and lower new store opening expenses. The firm has been able to reinvest cost savings into lower prices, which improve its price perception and ultimately protect the company's intangible asset moat source. We also think the acquisition of Wild Oats has proved to be value-accretive to shareholders despite less-than-ideal timing and a dividend cut. The board consists of 11 directors, nine of whom are independent. John Mackey, co-founder and co-chief executive officer, and Walter Robb, co-CEO, are the nonindependent board members. Mackey held both the CEO and chairman positions from 1978 through December 2009. He voluntarily gave up the chairman role in December 2009 for better governance. Mackey also divided his CEO role with Robb in May 2010. Before that, Robb served as co-president and chief operating officer from 2004 to May 2010, chief operating officer from 2001 to September 2004, and executive vice president from 2000 to February 2001. Executive compensation for both cash and stock at Whole Foods is in line with shareholder interests and based on a number of criteria that include comparable-store sales growth, earnings before interest, taxes, and noncash expenses, net operating profits after taxes (NOPAT), return on invested capital, and economic value added. Senior executive compensation at Whole Foods is below traditional grocery operator industry peers, despite much better performance. In 2007, Mackey voluntarily reduced his annual salary to \$1 and elected to forgo any future bonus and stock option awards. For the other senior executives, annual salaries are capped at 19 times the company's average annual wages.



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**Profile**

Whole Foods Market is the world's leading retailer of natural and organic foods and is the first Certified Organic grocer in the U.S. Whole Foods' only operating segment consists of natural and organic foods supermarkets. As of fiscal 2013, the company had 344 stores in the U.S., 8 stores in Canada, and 7 stores in the U.K. The average store size is about 38,000 square feet. During fiscal 2013, about 12% of the company's sales were derived from the sale of private-label products.

# EOG Resources Inc EOG | ★★★

\$86.72 ↓\$8.33 | -8.76%

Fair Value Estimate	<b>\$100</b>
Consider Buying Price	<b>\$70</b>
Consider Selling Price	<b>\$135</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

12-02-2014 | by Mark Hanson

## The Thesis 12-02-2014

Around the middle of 2011, the Eagle Ford took the lead-dog position in EOG's portfolio from the Bakken and hasn't looked back. Eagle Ford production increased eightfold from early 2011 to 2013, thanks to EOG's enviable position in the sweet spot of the oil window and improvement in drilling and completion methods that have helped the company deliver ever more impressive well results. With more than 10 years of remaining drilling inventory and an innovative crude-by-rail system helping to optimize prices, we don't expect EOG's Eagle Ford production to slow anytime soon. All this isn't to suggest that old man Bakken is dead. Down-spacing and secondary recovery efforts look promising and should help extend the productive life of this field. Beyond these two giants, EOG remains active in multiple fields across the Permian and continues to look for new horizontal liquids plays in and outside the U.S. EOG's liquids-rich assets--almost all of which have been proved up and captured since 2006--include dominant acreage positions in the Bakken/Three Forks and Barnett Combo plays and strong footholds in the Eagle Ford and Niobrara regions. EOG also holds oil-rich acreage in the Permian Basin (including its Leonard combo and Wolfcamp positions). We believe EOG's liquids-rich portfolio will generate the majority of the company's incremental production growth over the next handful of years, with especially strong contributions from the Eagle Ford region. Niobrara is a bit of a wild card for EOG, given the company's modest drilling activity to date, although with 215,000 net acres in this play and attractive preliminary well results, EOG is well positioned to ramp up activity should the economics prove compelling. EOG's gas assets include its substantial legacy position in the Barnett Shale, which should continue to generate strong production despite its relative maturity, as well as sizable acreage positions in the Horn River in Canada, the Haynesville/Bossier plays in eastern Texas and western Louisiana, and the Marcellus Shale in Pennsylvania. The firm is unlikely to commit any meaningful amount of capital to these plays until gas prices recover, however.

## Valuation

We are lowering our fair value estimate for EOG to \$100 per share from \$106, after updating our oil and gas futures prices and after reassessing the company's outlook given near-term weakness in commodity prices. Our fair value estimate implies a forward 2015 enterprise value/EBITDAX multiple of 8.0 times and is based on our five-year discounted cash flow model and an assessment of trading multiples, comparable transactions, and longer-term resource potential. We project average daily production of 3.6 billion cubic feet of equivalent in 2014, 4.0 bcfe in 2015, and 4.4 bcfe in 2016, with EOG's liquids production growing at a 23% compound annual rate over this period. We expect the Eagle Ford and Permian to drive most of EOG's oil and natural gas liquids production growth. In the Eagle Ford, we expect EOG to increase net production by more than 250 mboe/d from 2013 to 2016, reaching 400 mboe/d. In the Permian, we forecast a rig count of nine by 2016, with production increasing to 71 mboe/d. We project EOG's EBITDAX to reach \$9.6 billion in 2014, \$7.5 billion in 2015, and \$8.7 billion in 2016, driven by strong production growth.

EOG's hedges cover only a modest portion of our projected volumes, exposing the firm's cash flows to oil and gas price movements. Because EOG's portfolio contains acreage positions with significant resource potential that will take time and investment to convert to cash, we also consider longer-term reserve growth potential and the marketplace for these reserves in our valuation. Our analysis indicates that proven reserves could climb from 12.7 trillion cubic feet equivalent at the end of 2013 to 20.0 tcf by 2016. This growth trajectory in proven reserves and greater ultimate resource potential--considered within the context of historical marketplace transactions (on an EV/reserves basis)--supports valuation in line with our fair value estimate.

## Risk

EOG's biggest risk is a substantial and prolonged drop in oil and gas prices, which would depress profits, slow development plans, and reduce the value of its properties. Other risks include infrastructure bottlenecks that could reduce drilling activity or lead to lower selling prices, higher services costs given tight supply in emerging plays, and headwinds from Washington, D.C.--including budget proposals and stricter environmental regulations--that could eat into profitability.

## Management & Stewardship

EOG is led by Bill Thomas, who has more than 30 years of service with the company. He was named president in February 2011 and took over as CEO in mid-2013. EOG has demonstrated good stewardship over the years, with reasonable management compensation packages closely tied to returns on capital, a steadily increasing common stock dividend, and encouragement of equity ownership by key individuals through options issuance. EOG's executives currently own 1% of the common stock. We believe investors would benefit from greater and more consistent disclosure, however, especially regarding average operating metrics across certain plays.

## Profile

EOG Resources explores for, produces, and markets natural gas and oil primarily in North America, with additional operations in Trinidad, the United Kingdom, and China. The company focuses on horizontal drilling in unconventional plays. At year-end 2013, EOG's proven reserves totaled 12.7 trillion cubic feet of natural gas equivalent, with daily production of 3.1 bcfe. Natural gas made up 44% of production and 40% of reserves.

# Market Vectors® Gold Miners ETF GDX



\$18.36 ↑\$1.15 | 6.68%

ETF Valuation Rating (as of 12-04-2014)	<b>Fairly Valued</b>
ETF Market Price (as of 12-04-2014)	<b>\$19.25000</b>
Fair Value Estimate	<b>\$24.22</b>
Consider Buying Price	<b>\$17.19</b>
Consider Selling Price	<b>\$31.99</b>
ETF Expected Return	<b>17.87%</b>
ETF Hurdle Rate	<b>19.31%</b>
ETF Expected Excess Return	<b>-1.43%</b>
Morningstar Coverage	<b>61.83% of assets</b>
	<b>13 of 41 Holdings</b>
Stock Quality (as % of assets)	<b>% Wide Moat</b>
	<b>4.26% Narrow Moat</b>
	<b>57.56% No Moat</b>
Fair Value Uncertainty	<b>Very High</b>

03-26-2014 | by Samuel Lee

## The Thesis 03-26-2014

### Suitability

Gold miners' failure to ride the gold bull market up has traditionally been blamed on the rise of physical gold exchange-traded funds, which supposedly drew away investors who had used mining stocks to obtain gold exposure. While there may be a smidgen of truth to the story, it doesn't explain gold miners' continued weakness (markets are forward-looking) or the fact that miners underperformed gold even before the rise of ETFs.

A better explanation: Gold miners have historically been terrible capital allocators in an industry that requires continuous capital expenditures to replace tapped-out mines. For most of the bull market, miners kept payouts low, using their surging profits to acquire or develop more mines, the symptom of a short-sighted growth-at-all-costs mind-set. They issued torrents of new shares to fund their spending sprees. From the beginning of 2005 to the end of 2012, gold miners' aggregate market cap grew by more than 16% annualized, while their aggregate price grew only about 7.7% annualized. The 8% annualized gap between market cap and price performance represents share dilution. History shows that share issuances tend to signal future underperformance, in part because managers time the market to sell at peaks and in part because firms often fail to realize the expected benefits of major capital expenditures.

If the miners had just focused on returning cash to shareholders and keeping costs down, their stock returns would have been a sight to behold. It takes a colossal effort to fail to exploit operational leverage when the prices of your goods are skyrocketing. I'm sympathetic to the common opinion that gold miners are some of the worst-managed firms out there.

So, why own gold miners now after a history of epic waste, mismanagement, and, in some cases, fraud? First, the market has wised up to the sector's deficiencies. Miners now trade at very low valuations. The irony is this near-death experience is the catalyst needed to set gold miners straight, to clean out incompetent managers and hire people who'll focus on prudent capital allocation. Second, miners are now an attractive substitute for physical gold exposure. Finally, miners don't actually have to provide exceptionally high returns to be worthwhile because their low correlation

to conventional stocks and bonds mean they can improve a portfolio's overall risk-adjusted returns.

### Fundamental View

It's generally not a good idea to own firms that require large, ongoing capital expenditures under conditions of high uncertainty. Humans are overconfident and optimistic, so they tend to overestimate the rewards and underestimate the costs of major capital expenditures (whether it's a merger, a tunnel connecting New Jersey to New York, or a new mining complex). Managers are rewarded for short-term performance, but shareholders end up with long-term performance, so it's no surprise that managers often overstate the rewards of these big projects that don't pay out until years later.

There's also that dreaded institutional imperative at work, the tendency for managers to grow their companies just for the sake of growing. These aren't insoluble problems, of course. Oil firm Exxon Mobil XOM has faced similar problems and made shareholders a lot of money. XOM achieved this in large part because of its shareholder-centric culture. XOM's dividend has steadily grown since the 1970s. Few gold-mining firms have shown a similarly obsessive focus on prudent capital allocation and sustainable growth over as long a period. Of those Morningstar equity analysts cover, only Eldorado Gold Corp EGO earns the highest Stewardship Rating of Exemplary. Analyst Kristoffer Inton has written that only EGO has an economic moat as it, "boasts lower production costs relative to the rest of the gold mining industry, with total unit cash costs of just \$551 per ounce in 2013, compared with the average industry figure of close to \$700 per ounce." However, both firms were founded in the 1990s, whereas gold-mining has been a business for centuries--where did all the wide-moat firms of yesteryear go? They probably never existed.

David Einhorn is perhaps the most famous gold-miner bull right now (though there are plenty of others). As of Dec. 31, 2013, his hedge fund Greenlight Capital owned 8.8 million shares of Market Vectors Gold Miners ETF GDX, making him the fund's fifth-biggest institutional shareholder. Einhorn said in November 2011, "With gold at today's price, the mining companies have the potential to generate double-digit cash flow returns and offer attractive risk-adjusted returns even if gold does not advance further." GDX was then trading at nearly \$60 a share. Now it's trading under \$25 as of this writing.

Over the long run, gold miners will probably fail to offer attractive risk-adjusted returns, barring a big runup in gold prices or a cultural sea change. In the medium term, gold miners look like a decent buy. They could be a good long-term buy if managements are competent and gold prices don't take a nosedive. Two big ifs.

### Fees & Alternatives

The fund carries a reasonable 0.52% price tag, similar to comparable equity precious-metals funds. However, funds that hold the physical commodity are a bit cheaper. Van Eck has hired the Bank of New York Mellon as the fund's securities lending agent, who on behalf of the fund lends out the underlying shares for a bit of extra income. The funds pay "reasonable fees" and may share some of the income with the lending agent, but the annual report is vague as to how much the fund is paying the agent.

GDX is probably best held in a taxable account. Its high volatility means it offers ample tax-loss-harvesting opportunities. And its heavy international stake means U.S. investors may be able to recover some of the funds' foreign withholding taxes by taking a tax credit or deduction.

### Alternatives

GDX doesn't face much competition. It is by far the biggest, most liquid gold miner ETF, though not the cheapest. The second biggest miner fund is Market Vectors Junior Miners ETF GDXJ. It charges a tad higher expense ratio--0.55%--and invests in "junior miners," which are typically focused on the exploration and initial prospecting. The lotterylike payoff structure of this market segment has historically meant low risk-adjusted returns, as investors have been willing to pay dearly for the dream of hitting it big.

The lowest-cost fund, iShares MSCI Global Gold Miners RING, charges 0.39%, but its assets and secondary market liquidity are negligible. Unlike GDX, RING is able to own stocks listed on foreign exchanges, lending the fund a more mid-cap flavor.

Investors looking for direct exposure to gold should consider SPDR Gold Shares GLD or iShares Gold IAU. GLD is more heavily traded than IAU, but its 0.40% expense ratio is higher than IAU's 0.25%. GLD can be cheaper than IAU for rapid-fire traders who turn over their positions frequently owing to the fund's narrower bid-ask spread as a percentage of price.

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**Portfolio Construction**

This fund tracks the NYSE Arca Gold Miners Index, a modified market-cap-weighted benchmark of companies involved in gold and/or silver mining whose common shares, American Depositary Receipts (ADRs), or Global Depositary Receipts (GDRs) are listed and electronically quoted on a major exchange that can be accessed by foreign investors. Although most of the fund's holdings are primarily focused on gold mining, it also includes a handful of silver miners, such as Silver Wheaton Corp SLW. Most of the fund's holdings are based outside the United States.

Because the gold-mining industry is top-heavy, the index has diversification rules. No single stock can make up more than 20% of the portfolio, and stocks that each make up more than 4.5% of the portfolio are capped at 50% of the index's total assets. Despite the rules, the top three holdings make up more than a third of assets.

The index composition is reviewed and rebalanced quarterly.

# iShares Nasdaq Biotechnology IBB |



**\$303.90** ↑\$7.28 | 2.45%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$308.2500</b>
Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
ETF Expected Return	<b>8.01%</b>
ETF Hurdle Rate	<b>12.95%</b>
ETF Expected Excess Return	<b>-4.94%</b>
Morningstar Coverage	<b>73.44% of assets</b>
	<b>26 of 119 Holdings</b>
Stock Quality (as % of assets)	<b>23.18% Wide Moat</b>
	<b>42.20% Narrow Moat</b>
	<b>8.06% No Moat</b>
Fair Value Uncertainty	<b>High</b>

09-02-2014 | by Robert Goldsborough

## The Thesis 09-02-2014

### Suitability

Investors seeking exposure to the highly uncertain but potentially promising prospects of the biotech industry can consider adding iShares Nasdaq Biotechnology to their portfolios as a tactical satellite position to a diversified equity portfolio. This exchange-traded fund holds 121 biotech firms listed on the Nasdaq with market caps of at least \$200 million. More than 20% of assets are small-cap names applying innovative techniques to research, develop, and commercialize various drugs targeting certain diseases or therapeutic niches. The jarring pace of change, single-product liability, regulatory uncertainties, and intellectual property rights make picking stocks in the biotech sector a high-risk/high-reward proposition. As such, we think investing in the industry via an ETF makes a lot of sense; it's a low-cost way to gain diverse exposure to the industry in one trade. And this particular ETF may be best suited for investors looking for as much diversification as possible; it has the broadest number of holdings of any biotech ETF currently trading.

Unlike several competing biotech ETFs that track equal-weight indexes, this fund tracks a market-cap-weighted index, which ensures that the more-established, larger-cap biotech firms hold more sway. As a result, IBB has been less volatile over the past five years than any other biotech ETF and has been less volatile than all but one actively managed, biotech mutual fund. While an equal-weight strategy may sound like a reasonable choice for a lotterylike industry such as biotechnology, a cap-weighted strategy has resulted in better risk-adjusted returns over the past five and 10 years.

### Fundamental View

To win regulatory approval for a drug, a biotech company must take its therapy through a 10- to 15-year research and development gauntlet in a process that costs \$1 billion on average. After all that, success rates are low. Only about 20% of drugs reaching Phase I of clinical development ever actually hit the market. With all these factors, many smaller biotech firms don't turn a profit. Many give up their drugs' marketing rights to industry giants in exchange for royalties on sales and even cash upon reaching certain development milestones. The upshot: A biotech firm that can successfully bring its products to market will reap bountiful rewards, grow

significantly, and create an instant economic moat.

Led by large-cap biotechs, the shares of biotech firms have dramatically outperformed the broader market over the past five years. The firms at the top of this ETF, such as Regeneron REGN, Biogen BIIB, Celgene CELG, Gilead GILD, and Amgen AMGN, have led the rally, benefiting from key drug approvals, strong sales of already-approved drugs, an attractive regulatory environment, and successful integrations of the acquisitions of smaller players. Acquisitions by large pharmaceutical companies also have fueled the biotech space's performance, as Big Pharma has sought to improve its relatively empty drug pipelines in part by buying up biotech firms. That has culminated in deals such as GlaxoSmithKline's GSK acquisition in 2012 of Human Genome Sciences. Given Big Pharma's flush balance sheets, we expect more biotechs to be acquired by large pharmaceutical firms in the near term.

One issue facing the biotech industry is health-care reform. Medicaid started covering more people in 2014, which should be a positive for volumes and the drug industry. On the negative side, higher rebates already are in place for Medicaid patients, which means biotechs will see lower net prices for their drugs.

From a reimbursement standpoint, we like that most biotechs tend to focus on biologics that address serious, chronic, or life-threatening illnesses; this means that both government and private insurers will in fact reimburse as medical benefits the highly profitable infused drugs approved to treat major ailments. We also like that biotechs remain less vulnerable to generic competition than Big Pharma because of the difficulty of manufacturing, the cost of clinical trials, and the still-developing pathway for these products in the United States.

In our view, the biotech industry is much less susceptible to government intervention than other health-care subsectors--like hospital operators or MCOs. And we think an ETF is the appropriate tool for investing in this notoriously volatile subsector. One drug's odds of success typically have no bearing on another's; we like the diversification among individual firms that this fund offers, which helps protect against single-stock risk.

We're still cognizant that roughly half of this fund's holdings are early-stage players with no drug on the market yet. These smaller firms, with decidedly uncertain prospects but explosive upside potential, loom large. Bimodal businesses like upstart biotech firms--which are plentiful here--are very difficult to forecast, subjecting any fair value estimates to significant uncertainty. Thus, we'd demand a wide margin of safety before investing here.

## Fees & Alternatives

The fund's 0.48% expense ratio is reasonable, but cheaper ETF options exist. For instance, both SPDR S&P Biotech XBI and Market Vectors Biotech ETF BBH charge just 0.35%. Still, we think that IBB's price tag is quite reasonable given the biotech-industry diversification that it offers investors. What's more, IBB's estimated holding cost is a more attractive 0.23%. Estimated holding costs are primarily composed of the expense ratio but also include transaction costs, sampling error, and share-lending revenue.

### Alternatives

Investors seeking exposure solely to biotechs also can consider SPDR S&P Biotech XBI (0.35% expense ratio), which is a fairly concentrated, equal-weight portfolio. While its expense ratio is reasonable, XBI has lagged many peers across different time frames. XBI's 78-stock portfolio sports a holdings-weighted average market cap of \$2.0 billion.

An even more concentrated option is First Trust NYSE Arca Biotechnology Index FBT (0.60%), which has posted solid performance over the past five years. However, its performance has trailed IBB over the past few years, and it has displayed much greater volatility than IBB. It's also fairly pricey. FBT holds 20 biotech firms and clocks in at an average market cap of \$9.8 billion.

Two other ETF options are PowerShares Dynamic Biotech & Genome PBE (0.63%) and Market Vectors Biotech BBH (0.35%). The Market Vectors ETF is more of a traditional cap-weighted fund, holding the largest biotechs (think Amgen, Gilead, Celgene, and Biogen). As a result, BBH's portfolio of 25 biotech

stocks has an average market cap of \$28.8 billion. For a quantitative-active approach to the biotech subsector, investors also can consider PBE, which holds 30 names and has an average market cap of \$7.3 billion.

There also are several actively managed, open-end mutual funds offering exposure to biotech that investors might want to consider. These include Bronze-rated Fidelity Select Biotechnology FBIOX (0.75%), Rydex Biotechnology RYBOX (1.61%), and Franklin Biotechnology Discovery FBDIX (1.10%). However, these funds' performance largely has been comparable to IBB's, both in recent periods and over three- and five-year time frames, although the Rydex fund has lagged meaningfully over the past year.

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### Portfolio Construction

This ETF tracks the Nasdaq Biotechnology Index, which encompasses 121 Nasdaq-listed stocks that are either biotechnology or pharmaceuticals firms, as defined by the FTSE and Dow Jones' Industry Classification Benchmark. As a practical matter, this ETF is both in name and focus a biotech-heavy ETF, with about 78% of the assets in this ETF invested in firms that are classified as operating in biotechnology. The remaining 21.5% of assets are invested in small- and mid-cap pharmaceutical firms such as Mylan MYL, Salix SLXP, and Theravance THRX. (This ETF holds Nasdaq-listed firms only, and the U.S.' largest pharmaceutical firms trade on the New York Stock Exchange.)

IBB's index is one of eight subsectors that make up the Nasdaq Composite Index. While each firm must have an average daily trading volume of at least 100,000 shares and a minimum market cap of \$200 million, the portfolio spreads its assets across the market-cap range, with about 58% of assets in large caps, 21.5% in mid-caps, and 20% in small caps. The fund tracks a cap-weighted index and invests almost 58.5% of assets in its top 10 holdings. The holdings-weighted average market cap is \$16 billion.



# Financial Select Sector SPDR® ETF

XLF | ★★

\$24.40 ↑ \$0.56 | 2.35%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$24.56500</b>
Fair Value Estimate	<b>\$</b>
Consider Buying Price	<b>\$</b>
Consider Selling Price	<b>\$</b>
ETF Expected Return	<b>8.91%</b>
ETF Hurdle Rate	<b>20.25%</b>
ETF Expected Excess Return	<b>-11.34%</b>
Morningstar Coverage	<b>93.70% of assets</b>
	<b>69 of 86 Holdings</b>
Stock Quality (as % of assets)	<b>19.87% Wide Moat</b>
	<b>60.50% Narrow Moat</b>
	<b>13.11% No Moat</b>
Fair Value Uncertainty	<b>High</b>

07-17-2014 | by Robert Goldsborough

## The Thesis 07-17-2014

### Suitability

Financial Select Sector SPDR is appropriate as a tactical satellite holding for broad exposure to the U.S. financial-services sector. Unlike many other U.S. equity sectors, the financial-services sector still has never come back to its pre-crisis highs. The reasons for this have been well-documented, including greater regulation, continued ultralow interest rates, asset write-downs, and higher capital requirements.

The index this ETF seeks to replicate defines the financial-services sector broadly to include commercial banks, diversified financial-services firms, capital-markets companies, insurers, REITs, and consumer finance firms. The result is a market-cap-weighted portfolio of 84 firms with a certain amount of concentration, as XLF's top-10 holdings make up slightly less than 50% of its assets.

The financials sector offers high-beta exposure to the U.S. economy. The reason is that even seemingly small changes in unemployment and consumer confidence can have an outsize impact on loan repayment rates and the willingness to borrow. Other aspects of the economy, including the health of the housing market and even the shape of the yield curve, can provide headwinds or tailwinds for financials firms. In recent years, owning XLF has required investors to be comfortable with far more volatility as a whole. Indeed, XLF's 18.7% volatility of return over the past five years has been some 60% greater than the S&P 500 Index's 13.4% volatility of return over that same interval. An investor in this fund should have a high risk tolerance but could benefit from positive trends that may continue in the near term, including an improving macroeconomic environment, a further strengthening in the housing sector, and continued strong equity-market performance.

This ETF offers the diversification that we think is prudent in a sector where some aspects of companies' operations are so opaque that it can be difficult to gauge companies' true risk exposure. One need look no further than the multi-billion-dollar trading loss at J.P. Morgan JPM in 2012 to understand the perils of single-stock investing in the financial-services sector. The fund's comprehensive sector portfolio mitigates company-specific risk while offering pure exposure to the U.S. financial-services industry. We believe this ETF is an effective tool for investors seeking to

overweight the financials sector within a broadly diversified portfolio.

### Fundamental View

In the first half of 2014, the market performance of the U.S. financial-services sector trailed the broader U.S. equity market by several hundred basis points.

Thus far this year, there have been some small bumps in the road for a sector that has enjoyed a robust comeback during the past five years, but where volatility remains meaningfully high and uncertainty even higher. While no one doubts that large banks, which dominate the financial sector, are far better capitalized than they were heading into the financial crisis, the final results in March of the Federal Reserve's annual stress test on the United States' 30 largest banks demonstrate both a lack of robustness on the part of some large lending institutions—including Citigroup C—as well as the clear presence of a prominent headwind in the form of elevated compliance, regulatory, and legal costs across the industry.

Another headwind is the U.S. economy. While it unquestionably has shown some bright spots during the past several years, concerns about a less-than-strong economy generally have weighed on banks, which feel less inclined to lend in such an environment. Less lending means less growth for banks.

Interest rates remain a major issue for the financial-services sector. Continued low interest rates have meant continued pressure for banks' net interest margins. Morningstar's equity analysts don't expect interest-spread revenue at U.S. banks to grow anytime soon. Instead, it's more likely that low loan yields will mean interest-spread revenue will remain the same or even decline. Another issue that remains a major headwind for U.S. banks is recurring regulation and litigation expenses, which continue to hit banks' income statements. Other headwinds for U.S. banks include higher compliance costs and still-high unemployment, which generally tends to keep borrowing and repayment rates low.

To counteract lower spread revenue and thus tighter margins, U.S. banks have continued to reduce expenses, including cutting staff and branch locations. Banks have not been shy about shuttering underperforming branches that cannot justify their continued operation. U.S. banks have positioned themselves well for the future; stress tests show that U.S. banks generally are better capitalized than in the past and can withstand serious economic shock. As a result of the aggressive steps banks have taken to recapitalize in the wake of the financial crisis and conservative underwriting in recent years, banks' capital ratios are improving. The stronger housing market also has lessened the need for reserves, allowing banks to reduce provisions for loan losses. (Banks broadly have had modest success growing their balance sheets.)

Elsewhere in the financial-services industry, we continue to hold the view that investment banks and asset managers will follow the market. Investment banks have been enjoying strong underwriting volumes, and the strength in the equity markets has boosted the earnings of investment banks with asset management businesses. One clear concern with investment banks is the prospect of higher interest rates and their possible impact on debt underwriting, fixed-income trading, and the valuation of the banks' fixed-income securities. Certainly for asset managers, flows have tapered off, particularly in the fixed-income market.

One other issue facing XLF relates to European banks. European-domiciled financials firms make up a minuscule 2.2% of the assets of this ETF. However, problems with Europe's economy could have a contagion effect on large U.S. banks, because European banks are counterparties to large U.S. banks. As such, a continued inability to solve sovereign debt problems in Europe could eventually cascade across the Atlantic, and we could see U.S. banks stuck absorbing some of the losses. That said, European banks are finally starting to catch up to their U.S. counterparts on the capital front, reducing this risk (although they still meaningfully lag those of U.S. banks).

### Fees & Alternatives

The fund's 0.16% expense ratio is lower than its closest peers'. Its high trading volume and deep asset base keep its bid-ask spread tight. State Street engages in share lending, the practice of lending out the fund's underlying shares in exchange for a fee. It passes 85% of the gross proceeds to investors, which partially offsets the fund's expenses.

### Alternatives

Vanguard Financials ETF VFH dips further down the market-cap ladder to offer broader exposure to the U.S. financial industry. It owns all 539 financial-services firms in the MSCI U.S. Investable Market 2500 index, including mid- and small-cap companies. VFH is also less top-heavy. Its top 10 holdings account for 36% of the portfolio. This better diversification gave VFH a slightly less volatile profile than XLF over the past five years. Yet, during that time, these funds were nearly perfectly correlated. VFH charges 0.19%. We wouldn't recommend another large and liquid option, iShares U.S. Financials IYF, which offers a broad portfolio of 272 financial-services firms but charges an unappealing 0.44% fee. During the past five years, IYF and XLF were nearly perfectly correlated.

A recently launched and very inexpensive option is Fidelity MSCI Financials ETF FNCL, which charges 0.12%. However, FNCL has minimal assets and is thinly traded. FNCL tracks a slightly different index from Vanguard Financials ETF; FNCL tracks the MSCI USA IMI Financials Index, while VFH tracks the MSCI US Investable Market Financials 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FNCL commission-free, although they are subject to a short-term trading fee by Fidelity.

Investors looking for more direct exposure to U.S. banks and less exposure to nonbank financial institutions might consider SPDR S&P Bank ETF KBE. This fund offers equal-weight exposure to 58 U.S. banks, with more than two thirds of the portfolio invested in small- and mid-cap companies. KBE charges 0.35%.

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### Portfolio Construction

The fund employs full replication to track the S&P Financial Select Sector Index, which includes all financials stocks in the S&P 500. This modified market-cap-weighted benchmark limits individual constituents to 23% of the index, and the sum of securities whose weightings are greater than 4.8% cannot exceed 50% of the index. These limits allow XLF to qualify as a Regulated Investment Company. S&P rebalances the index quarterly.

**Consumer Discret Sel Sect SPDR® ETF**

XLY | ★★★★★

\$71.81 ↑\$3.71 | 5.45%

ETF Valuation Rating (as of 12-04-2014)

ETF Market Price (as of 12-04-2014) **\$71.41000**Fair Value Estimate **\$**Consider Buying Price **\$**Consider Selling Price **\$**ETF Expected Return **9.42%**ETF Hurdle Rate **20.00%**ETF Expected Excess Return **-10.58%**Morningstar Coverage **94.30% of assets****71 of 85 Holdings**Stock Quality (as % of assets) **49.75% Wide Moat****31.64% Narrow Moat****12.71% No Moat**Fair Value Uncertainty **High**

09-12-2014 | by Robert Goldsborough

**The Thesis** 09-12-2014

## Suitability

Consumer Discretionary Select Sector SPDR XLY offers investors exposure to firms in the S&P 500 Index that largely depend on discretionary consumer spending. The low-cost, highly liquid exchange-traded fund, which holds 85 companies, is fairly concentrated and owns retail firms, restaurants, media companies, apparel and luxury goods companies, automobile manufacturers, and leisure firms. This ETF is best treated as a tactical satellite holding to complement a diversified portfolio and for investors looking to bulk up their exposure to the consumer.

Over the past 10 years, this ETF has had a volatility return of 18.2%, compared with the S&P 500 Index's volatility of return of 14.7%. XLY's five-year beta relative to the MSCI ACWI Index is 0.91. That's in the middle relative to the betas of competing consumer discretionary ETFs. That means that XLY would be expected to exhibit more volatility across a cycle than competing fund iShares US Consumer Services IYC, which has a five-year beta relative to that benchmark of 0.84, but less volatility than Vanguard Consumer Discretionary ETF VCR, whose five-year beta relative to that index is 0.97. The biggest difference between the three ETFs is that IYC holds Wal-Mart WMT (which is IYC's top holding), while the other two funds do not.

## Fundamental View

Investors should take note that the Consumer Discretionary Select Sector SPDR is a cyclical play tied to consumer spending. At the same time, cyclical firms usually do rally before the economy fully emerges from a slump.

Consumer confidence in the United States has continued to advance. In August 2014, a key measure of consumer confidence, the Thomson Reuters/University of Michigan's consumer sentiment index, increased to the index's highest reading since July 2007. At the same time, consumer spending fell slightly (0.1%) in July 2014, which was its first decline in six months. Consumer spending has been mostly on an upward trajectory for more than a year, and many economists forecast that to continue in the near term, amid growing confidence and some continued improvement in macro trends, such as employment, business spending, and manufacturing. Job gains, a rebounding housing market, and a stock market that continues to hit highs offer good reasons to be bullish on consumer confidence in the

medium term. Morningstar's director of economic analysis Robert Johnson forecasts gross domestic product growth of 2.0% to 2.5% in 2014, with employment growth of 190,000 jobs per month and inflation at 1.8% to 2.0%. He also anticipates consumer spending that is stable to modestly higher.

While it's not news that e-commerce has become a growing force in the North American retail industry, e-commerce may have hit a tipping point in 2014 as consumers' embracing of online shopping has seemed to be accelerating and leaving many traditional bricks-and-mortar retailers unable to keep up. Up to now, many traditional retailers have followed an omnichannel strategy, and it was reasonably effective in 2013 for a number of publicly traded retailers, which adopted tactical measures to compete with online retailers, such as price-matching efforts, other promotional activities, store-within-store partnerships with key suppliers, online order fulfillment from local stores, and even the development of mobile phone apps that enhance in-store shopping trips.

The 2013 holiday season may have marked a change, as Amazon has continued to boost its fulfillment capabilities while also remaining a formidable competitor from a pricing standpoint. Investors interested in the retail space should note that some traditional retail business models, such as home-improvement and auto-parts retail, have characteristics that insulate them from e-commerce competition (need for salesperson help, immediacy of need, specialized nature, diversity of product assortment), other areas of retail, such as toys, office supplies, and consumer electronics, should expect to see continued price compression as consumers shift to e-commerce.

Because of these recent headwinds, the consumer discretionary sector is relatively undervalued right now, according to Morningstar's equity analysts. It strikes us that some fairly short-term dynamics are pressuring a good number of consumer discretionary names, and we could see a number of those reversing (or at least ceasing to be drags). For the sector to outperform in the medium term, we would expect to see further gains in the housing and job markets, with real wage growth. In addition, the global stage would need to take part as well, with rebounding strength in Europe and, in particular, emerging markets. (We like the idea of a growing base of middle-class consumers in emerging markets helping to offset broader economic concerns over the long run.) With those factors in place, we could see the consumer discretionary sector resuming its rally.

Although all of this ETF's holdings are domiciled in the U.S., many of the companies have significant operations overseas, and those holdings have the potential to be affected by a slower world economy that is being forecast. The good news is that emerging markets are showing signs of stabilization, even if Europe's problems are further away from being solved. Some of this ETF's holdings with the most overseas exposure are restaurant operators such as McDonald's MCD (foreign operations make up 68.5% of revenue, and Europe represents 40% of sales) and Yum Brands YUM (foreign operations represent 77.5% of sales). If Europe continues to struggle or emerging-markets countries began slowing again, that could impede both companies.

Media companies make up the biggest slice of this ETF, comprising about 30.5% of assets. However, very little of this fund's media stake is invested in "old media" companies like Gannett GCI. Instead, XLY holds a raft of entertainment companies and cable network owners, such as Walt Disney DIS, Twenty-First Century Fox FOXA, and Viacom VIAB, as well as cable and satellite system companies such as Comcast, Time Warner Cable, and DirecTV DTV. Although entertainment firms often face choppy results from the hit-or-miss nature of blockbuster movies, firms like Disney, News Corp., and Viacom possess deep libraries of content that can reduce volatility and generate stable cash flows. When evaluating those firms, investors also should watch economic trends closely, as economic stagnation can have a meaningful impact on the broadcast and cable networks those firms own. Meanwhile, the cable and satellite system companies have broad coverage but operate in what we consider to be fairly mature markets (thus driving Comcast and Time Warner to pursue a merger). They also are finding themselves with some tough competitors, including phone companies and Internet-based video distribution.

**Fees & Alternatives**

The fund's 0.16% expense ratio is low, although there are lower-priced funds in the consumer discretionary space. Vanguard Consumer Discretionary ETF VCR charges slightly less, at 0.14%, and Fidelity MSCI Consumer Discretionary Index ETF FDIS charges 0.12%. XLY's estimated holding cost of 0.20% is slightly higher than its expense ratio. Estimated holding costs are primarily composed of the expense ratio but also include transaction costs, sampling error, and share lending revenue.

#### Alternatives

There are several alternatives for comparable exposure to discretionary consumer spending. Investors can consider Vanguard Consumer Discretionary ETF VCR (0.14% expense ratio), which--given that it holds 386 companies--is a far more diversified way to invest in the space.

Another option is First Trust Consumer Discretionary AlphaDEX FXD (0.70%), which spreads its 133 stocks more evenly; its top 10 holdings comprise 14% of assets. This ETF uses an enhanced index that takes valuation into account when it draws component firms. Because of that structure, its holdings generally are less "growthy" than those found in XLY or VCR. Despite its higher price and its stock-selection methodology, FXD's performance has slightly lagged its larger consumer discretionary ETF peers over the past three and five years.

A recently launched and very inexpensive option is Fidelity MSCI Consumer Discretionary ETF FDIS, which charges 0.12%. However, FDIS has minimal assets and is thinly traded. FDIS tracks a slightly different index from Vanguard Consumer Discretionary ETF; FDIS tracks the MSCI USA IMI Consumer Discretionary Index, while VCR tracks the MSCI US Investable Market Consumer Discretionary 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FDIS commission-free, although they are subject to a short-term trading fee by Fidelity. An international option is iShares Global Consumer Discretionary RXI (0.47%). However, investors should note that with this fund they are essentially getting an overweighting to the automotive industry, given that RXI's top 25 holdings include Toyota TM, Daimler, Ford F, Volkswagen, General Motors GM, and Honda HMC.

The performance of all of the above-mentioned ETFs is very highly correlated. The high performance correlations between all consumer discretionary ETFs give us all the more conviction in urging investors to consider the option with the best combination of liquidity and price, VCR. In addition, VCR's estimated holding cost is just 0.09%.

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#### Portfolio Construction

XLY follows a full replication strategy and holds every consumer discretionary stock in the S&P 500 Index. The sector comprises about 12% of the broader S&P 500 Index. Sticking to S&P 500 companies provides an initial screen for quality, as holdings must meet the standards of the S&P selection committee. The fund makes dividend distributions on a quarterly basis. As one of the Select Sector SPDR ETFs, XLY follows S&P's rules for index construction. S&P has the flexibility to make changes to the S&P 500 Index any time as needed, with no annual or semiannual reconstitution. Then, a company's stock is assigned to a particular Select Sector index on the basis of its sales and earnings composition and on the sensitivity of its stock price and business results to the common factors affecting other companies in each Select Sector index. Under the rules, every constituent in the S&P 500 Index is assigned to a particular Select Sector index, and no company can be included in more than one index.

# Utilities Select Sector SPDR® ETF XLU



\$46.00 ↑ \$0.53 | 1.17%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$46.27000</b>
Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
ETF Expected Return	<b>5.33%</b>
ETF Hurdle Rate	<b>8.94%</b>
ETF Expected Excess Return	<b>-3.61%</b>
Morningstar Coverage	<b>100.00% of assets</b>
	<b>31 of 31 Holdings</b>
Stock Quality (as % of assets)	<b>5.35% Wide Moat</b>
	<b>91.09% Narrow Moat</b>
	<b>3.29% No Moat</b>
Fair Value Uncertainty	<b>Medium</b>

10-03-2014 | by Robert Goldsborough

## The Thesis 10-03-2014

### Suitability

Utilities Select Sector SPDR XLU is an option for investors who want broad exposure to defensive, high-yielding United States utilities companies. This fund's holdings include regulated utilities, diversified utilities, and unregulated power generators, and such companies are known for their reliability and income generation. This exchange-traded fund is suitable as a satellite holding for a diversified equity portfolio, given that the utilities sector makes up about 3% of the S&P 500 Index. The fund also can serve as a tactical bet on low interest rates and long-term growth in electricity demand.

Like most ETFs that invest in utilities companies, XLU pays a healthy yield. The fund is currently yielding 3.8% and over the past few years, its yield has averaged around 4.2%.

Prior to 2000, utilities' reputation among investors was one of reliability and income generation, and not necessarily price appreciation. However, since that time, the long decline in interest rates likely broadened utilities companies' investor base. However, since the yield spread--the difference between utilities companies' dividend yields and 10-year U.S. Treasury rates--began its compression in June 2012, utilities companies have meaningfully trailed the broader equity market. Longer-term, in a rising-rate environment, we would expect flat returns at best for utilities companies and underperformance when compared with other equity sectors. Higher rates generally make fixed-income instruments more attractive on a relative basis and make bondlike equities, such as utilities companies, less attractive.

This ETF's volatility is low. Over the past five years, this ETF's volatility of return of 11.7% is lower than the 13.2% that the S&P 500 Index has experienced.

### Fundamental View

The U.S. utilities sector has posted strong recent performance. Since the start of 2014, the utilities sector has significantly outperformed the broad U.S. equity market after lagging it (and every other U.S. equity sector) by a meaningful amount in 2013. Even so, 2013 was a historically good year for utilities companies, whose 14% total return was nearly twice the sector's long-term annual return.

Driving utilities companies in 2014 have been two dynamics: weather and interest

rates. Early in the year, extreme winter weather helped utilities companies and in particular gas utilities. Then, another pullback in interest rates has been a nice benefit for the highest-yielding and most-defensive utilities. Right now, Morningstar's equity analysts believe that utilities appear to be pricing in 4% 10-year U.S. Treasury rates. That means that even a modest rise in interest rates should not be a meaningful negative for the share prices of utilities companies. Our analysts also believe that if Treasury rates stabilize closer to 3%, utilities actually could outperform the market.

Because dividends are such a major part of the story for investors in utilities companies, it's worth discussing the outlook for payout ratios. The headline is that we see no wholesale threat to dividends across the sector. Given strong company fundamentals, our equity analysts are forecasting a sector average payout of 59% for 2014, which is in line with historical averages. In addition, with sustainable payout ratios, our analysts believe that dividends could grow as much as 5% annually, which bests the median 3% earnings growth that investors have seen in the sector during the past three years.

Several dynamics that utilities-sector investors should watch closely include continued low electricity demand, the impact of low natural gas prices on higher-cost coal and nuclear plants (and broadly, on unregulated power producers), and new environmental regulation, which could result in coal plant closures, reduced emissions, and increased capital investments. In the medium term, new environmental regulation could have the effect of taking plants off line, resulting in power shortages, higher power prices, and a boost for diversified utilities and independent power generators over the next five to 10 years.

To cope with low power prices in the short run, diversified utilities and independent power producers continue to pursue mergers and acquisitions to improve cost efficiency and geographic diversification and to expand into new growth markets. Good-sized recent deals include Exelon's EXC proposal to acquire Pepco POM, Berkshire Hathaway's BRK.A December 2013 acquisition of NV Energy, Exelon's acquisition of Constellation Energy, UIL Holdings' UIL bid for Philadelphia Gas Works, TECO Energy's TE September 2014 acquisition of New Mexico Gas, and NRG Energy's NRG acquisition of GenOn Energy. (Another big merger was Northeast Utilities' NU purchase of NSTAR, but those are both regulated utilities, so the merger had nothing to do with power prices and everything to do with cost efficiencies.) If power prices remain low, industry consolidation will likely continue. Most utilities companies include debt as part of their capital structure, generally borrowing to fund capital expenditures and issuing dividends from retained earnings. Regulated utilities are by definition subject to regulators, who allow utilities companies to pay dividends, borrow for capital expenditures, and then raise rates to fund debt service. Payout ratios for utilities companies generally are in the 50%-60% range, with a very stable outlook for those ratios. Our analysts assign most regulated utilities narrow moats, as they have reliable cash-flow streams and some monopolylike characteristics but also are subject to regulators. Our analysts assign no moat to unregulated utilities, which are effectively commodity producers with no differentiated characteristics.

## Fees & Alternatives

The fund charges a reasonable 0.16% expense ratio, making it the second-lowest-cost, large and liquid utilities fund available. Both the fund and its holdings are liquid, which keeps its bid-ask spread tight and minimizes deviations from net asset value. State Street engages in share lending, the practice of lending out the fund's underlying shares in exchange for a fee. It passes 85% of the gross proceeds to investors, which partially offsets the fund's expenses.

### Alternatives

Investors looking for better-diversified exposure to the utilities sector should consider Vanguard Utilities ETF VPU. VPU extends its reach further down the market-cap ladder and rests on a broader base of 78 stocks. Despite its better-diversified portfolio, VPU exhibited volatility comparable to XLU over the past five years. VPU's 0.14% expense ratio is less than XLU's, but the Vanguard fund is less than one third its size, which may give it a wider bid-ask spread. Over the past five years, VPU and XLU were nearly perfectly correlated.

iShares U.S. Utilities IDU is a more-expensive alternative. Its fees take a 0.43% bite

out of the fund's returns each year. For this hefty price, investors get a portfolio of 60 large-, mid-, and small-cap stocks in the Dow Jones Utilities Index. However, more than 95% of IDU's assets overlap with VPU. IDU also has less than half the assets of VPU.

A recently launched and very inexpensive option is Fidelity MSCI Utilities Index ETF FUTY, which charges 0.12%. However, FUTY has minimal assets and is thinly traded. FUTY tracks a slightly different index from Vanguard Utilities ETF; FUTY tracks the MSCI USA IMI Utilities Index, while VPU tracks the MSCI US Investable Market Utilities 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FUTY commission-free, although they are subject to a short-term trading fee by Fidelity.

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### Portfolio Construction

XLU tracks the Utilities Sector Select Index, investing in all 30 utilities companies in the S&P 500 Index, and it weights these holdings in proportion to their float-adjusted market capitalization. S&P's cap-weighting approach limits individual positions to 19% of the portfolio, though XLU's largest holding falls well below that mark. Electric utilities represent 56% of the portfolio, but diversified utilities also have meaningful weight (38%). Gas utilities and independent power producers & energy traders respectively account for 4% and 1% of the portfolio. Because of its limited number of holdings, the portfolio is highly concentrated. The top 10 holdings soak up more than 59% of the fund's assets. Additionally, its holdings only account for between 3% and 4% of the total assets in the S&P 500. XLU has consistently fallen in the deep-value zone of the Morningstar Style Box.



# Industrial Select Sector SPDR® ETF

XLI | ★★★

\$56.91 ↑\$1.70 | 3.08%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$57.41500</b>
Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
ETF Expected Return	<b>7.76%</b>
ETF Hurdle Rate	<b>15.77%</b>
ETF Expected Excess Return	<b>-8.02%</b>
Morningstar Coverage	<b>92.38% of assets</b>
	<b>53 of 65 Holdings</b>
Stock Quality (as % of assets)	<b>52.11% Wide Moat</b>
	<b>37.86% Narrow Moat</b>
	<b>2.25% No Moat</b>
Fair Value Uncertainty	<b>High</b>

09-17-2014 | by Robert Goldsborough

## The Thesis 09-17-2014

### Suitability

Investors seeking industrials-sector exposure can consider the sector-specific exchange-traded fund Industrial Select Sector SPDR XLI. This ETF holds aerospace and defense firms (26% of assets), industrial conglomerates (18.5%), machinery companies (17.5%), and transportation companies (11%).

Like all Sector SPDR ETFs, this fund draws its holdings from the S&P 500 Index, ensuring that its portfolio is composed of high-quality, large-cap companies. Many of XLI's holdings also have significant sales outside of the United States, giving this fund exposure to global growth trends. At the same time, the U.S. industrials sector is exposed to a meaningful amount of cyclical volatility. That cyclical volatility, coupled with this ETF's narrow sector focus, makes this ETF more volatile than other, broader ETFs. During the past 10 years, XLI has had a volatility of return of 18.7% compared with 14.7% for the S&P 500. XLI's historic volatility has been very comparable to that of other industrials sector ETFs.

This ETF is the most liquid fund in its peer group, and it also has one of the lowest expense ratios of any industrials ETF. It's suitable as a complementary satellite holding in a diversified portfolio.

### Fundamental View

The U.S. industrials sector continues to post strong results. The August 2014 ISM report showed that economic activity in the manufacturing sector had expanded for the 15th consecutive month. The report's manufacturing PMI (purchasing managers) index registered 59.0%, which was its highest reading since July 2011. In addition, the report showed growth in 17 of 18 manufacturing industries during August 2014, and posted its highest new orders index since April 2004. A separate manufacturing PMI survey from Markit released in early September 2014 gave a reading of 57.9 for August, which was well above the 55.8 reading in July 2014 and the highest reading in more than two years. (A PMI of more than 50 represents expansion of the manufacturing sector compared with the prior month.) Manufacturing output did decline in August 2014 for the first time in seven months, but that was the result of a decline in auto production (which otherwise has been very strong this year) owing to a temporary seasonal adjustment issue.

Broad-based strength in U.S. manufacturing in 2014 suggests further growth in the economy. Some purchasing managers have been citing geopolitical concerns, but largely, the strong data suggest that managers anticipate stronger spending by businesses and consumers.

Several segments of the industrials sector bear watching closely. Europe and China continue to be weak. U.S. nonresidential construction still hasn't yet turned a corner. And although the U.S. housing market has finally begun a bit of a rebound, it's not clear yet if that will be a sustained rebound. Until recently, the housing market had gone through a lengthy period of weakness, amid higher home prices, lower builder confidence, and declining existing-home sales.

The aerospace and defense industry is a major part of the industrials sector, and there appears to be no end in sight for austere government budgets. While the managements of mega-cap players in this space such as Boeing BA, General Dynamics GD, Lockheed Martin LMT, and Northrop Grumman NOC have worked to adjust staff and facilities to protect profits in the face of slowing or even declining revenue, there is no question that these firms' strong product offerings are going to be overwhelmed by government budget issues for the near and medium term.

Meanwhile, another key subsector in the industrials sector is the auto industry. U.S. auto sales had a slow start to the year in part due to poor weather, but picked up nicely in the spring of 2014, posting eight-year highs. European auto sales are continuing their strong growth this year after a robust 2013.

On the ground, trucking firms and railroads have enjoyed mostly strong results. Trucking and rail volumes have been fueled by rebounding agricultural volumes, strong chemical volumes, solid metals and construction volumes, coal volumes (for Western rail carriers), and decent intermodal volumes.

The industrials sector is a cyclical sector, which means it typically does better in the early and middle stages of the business cycle. However, some subsectors have unique drivers. For instance, defense contractors are more sensitive to government spending than the overall business cycle, and ongoing sequestration is hurting them regardless of where we are in the cycle. And if nonresidential (commercial) construction finally turns a corner, we would expect later-cycle capital goods manufacturers held in this ETF to benefit, such as Emerson Electric EMR, Caterpillar CAT, and Parker Hannifin PH. In addition, a stronger international picture would be a boost to transport and logistics firms such as Expeditors EXPD, C.H. Robinson CHRW, UPS UPS, and FedEx FDX.

## Fees & Alternatives

XLI's annual expense ratio is 0.16%. Vanguard Industrials ETF charges less (0.14%) but is far less liquid.

### Alternatives

A very similar fund is Vanguard Industrials ETF VIS, which holds 353 companies and has returns that are highly correlated to those of XLI. VIS has much lower trading volumes relative to XLI, however. VIS' expense ratio is a very attractive 0.14%. The two funds' performance and returns are similar, but the two ETFs do have small portfolio differences. VIS holds airline companies, while XLI does not. Also, XLI has slightly higher exposure to aerospace and defense companies (26% of assets) than does VIS (21%).

A recently launched and very inexpensive option is Fidelity MSCI Industrials ETF FIDU, which charges 0.12%. However, FIDU has minimal assets and is thinly traded. FIDU tracks a slightly different index from Vanguard Industrials ETF; FIDU tracks the MSCI USA IMI Industrials Index, while VIS tracks the MSCI US Investable Market Industrials 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FIDU commission-free, although they are subject to a short-term trading fee by Fidelity.

For investors interested in more global exposure, one industrial ETF is an attractive option. iShares Global Industrials ETF EXI holds both U.S. and international industrials names. EXI charges an expense ratio of 0.47% and splits its domestic and international exposure almost straight down the middle, with U.S. industrials names comprising 50% of the fund's assets. EXI has meaningfully underperformed XLI over the past one-, three-, and five-year periods, likely because of EXI's 15%-plus weighting to Japanese stocks and its meaningful exposure (more than 25%) to European companies.

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**Portfolio Construction**

One of nine Select Sector SPDRs, this fund tracks the industrials sector of the S&P 500 Index and holds 64 companies. XLI's holdings are market-cap-weighted, with the top 20 accounting for almost 68% of the total portfolio. The largest subsector weightings are aerospace and defense, industrial conglomerates, and machinery, which account for 26.0%, 18.5%, and 17.5% of fund assets, respectively.

Note that this fund does not hold any steel or materials companies. Investors looking for exposure to that sector can take a look at Materials Select Sector SPDR XLB or Vanguard Materials ETF VAW.

# Yum Brands Inc YUM | ★★★

\$77.25 ↑\$5.42 | 7.55%

Fair Value Estimate	<b>\$80</b>
Consider Buying Price	<b>\$56</b>
Consider Selling Price	<b>\$108</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

10-10-2014 | by R.J. Hottovy

## The Thesis 10-10-2014

Yum Brands is one of the more compelling global growth stories in our consumer coverage. Its core brands--KFC, Pizza Hut, and Taco Bell--occupy leading category positions and possess sizable international appeal, which should help extend its leadership in China and succeed in other emerging markets. Although rivalry among quick-service restaurants is on the rise globally, we remain optimistic about Yum's ability to generate positive returns thanks to an economic moat stemming from its brand intangible assets, cohesive franchise network, bargaining clout with suppliers, and scale advantages. Yum China will come under pressure during the back half of 2014 and early 2015 after food-quality concerns at one of the region's key beef and poultry suppliers, but we remain confident that its brands can withstand these issues. Although we anticipate double-digit comp declines from Yum China in the back half of 2014, we believe quality-assurance marketing and a menu revamp can help mitigate brand impairment issues. We remain optimistic about Yum's potential in China due to an established distribution infrastructure and local site development teams, and find management's division goal of 20% restaurant margins and 15% normalized operating income growth feasible based on low double-digit unit growth, midteen system sales growth, and moderate G&A expense leverage (but partly tempered by promotional activity and labor cost inflation). With roughly 40% of Yum's operating income coming from China, the stock is tied to market perceptions of macro and consumer trends in the region. However, we view Yum as more than a China story, and encourage investors to evaluate Yum's other divisions. As Yum shifts to a brand reporting structure (KFC, Pizza Hut, and Taco Bell have been consolidated by brand in every region except China and India), we expect accelerated unit and comp growth with margin expansion through centralized brand support and best practice sharing across regions. Although we recognize near-term emerging market consumer headwinds, we view these pressures as temporary and view a companywide long-term goal of 10% operating income growth as reasonable.

## Valuation

Although management's updated outlook for 2014 (provided on its third-quarter update) was a shade below our expectations amid top-line pressures and subsequent operating expense deleverage in China due to negative publicity surrounding a former food supplier, we're maintaining our \$80 fair value estimate. Our fair value represents fiscal 2015 price/earnings of 21 times, enterprise value/EBITDA of 11 times, and a free cash flow yield of around 4%. Our assumptions remain more conservative than management's internal DCF projections (which pegs the intrinsic value of the stock at \$85 to \$95 per share) and its sum-of-the-parts valuation (which implies values of approximately \$40, \$34, and \$16 per share for the China division, global franchising fees and licensing revenue streams, and company-owned restaurants outside of China, respectively). Based on recent sales pressures in China, we've cut our consolidated revenue growth forecast to 3% in 2014 (versus 4% previously). For the full year, we now anticipate Yum's China division to post high-single-digit unit growth, a nominal decline in same-store sales growth (with double-

digit declines in the back half of the year negating 12% comps in the first half of the year), 16% restaurant margins (implying 50 basis points of improvement), and a little more than 11% operating income growth. In Yum's other regions (formerly the U.S. and YRI segments), we anticipate low-single-digit comp growth amid increased competition and emerging market consumer spending pressures and low-single-digit unit growth, bringing our consolidated revenue growth forecast to 7% for KFC and 2% for Pizza Hut. We've assumed a low-single-digit revenue decline for Taco Bell in 2014 due to refranchising efforts. Over the next 10 years, we assume Yum will grow to almost 60,000 restaurants (including nearly 14,000 units in China) and deliver global comps in the low- to mid-single-digit range, bringing our average 10-year revenue growth forecast to 8%. We expect consolidated restaurant margins to improve 20 basis points to 15.2% and operating margins to expand by between 200 basis points in 2014 to 15.7%. We view management's updated EPS outlook for 2014 calling for an increase of 6%-10% (implying \$3.14-\$3.27) as realistic. However, we expect longer-term contribution from additional franchise locations, new sales layers, and increased scale in emerging markets, which should help to drive consolidated operating margins to just under 20% by 2023.

## Risk

Rivalry among quick-service and fast-casual restaurants is on the rise, with chains increasingly competing with one another on price, product differentiation, and across different dayparts. We generally view the U.S. quick-service restaurant industry as mature, suggesting players will increasingly fight each other for market share. In addition to industry competition, Yum and its franchisees must contend with an uneven consumer spending environment, aggressive and often irrational industry promotional activity, wage inflation, and volatile commodity costs, each of which could diminish profitability. Moreover, credit market volatility could impede franchisees from adding new restaurants, performing renovations, or purchasing equipment. With approximately 40% of total operating profits coming from its China segment the past three years, Yum is more sensitive to fluctuations in the region than its peers, including currency movements, increased labor costs, the sustainability of GDP growth, and negative publicity tied to food quality concerns. Additionally, we believe the company will face increasing competition from McDonald's and other Western quick-service restaurant rivals as they expand further in China and other foreign markets.

## Management & Stewardship

In May 2014, Yum outlined a succession plan for current CEO David Novak. Novak will make the transition to the role of executive chairman on Jan. 1, 2015, with current Taco Bell CEO Greg Creed taking the reins as Yum's CEO. In conjunction with the CEO succession, Novak plans to form the office of the chairman, which will include vice chairman and Yum China CEO Sam Su and Creed, to develop the longer-term strategic vision for the company. We view Creed as a wise choice to succeed Novak. Under Creed's leadership, Taco Bell has been one of the bright spots in the otherwise lackluster U.S. quick-service restaurant category the past few years, highlighted by strong product innovation (namely Doritos Locos Tacos and the Cantina Bell platform). Creed has helped to position Taco Bell as a potentially global brand, with management targeting \$14 billion in system sales by 2022, driven by new unit development, daypart expansion, and other store productivity measures. We believe many of the initiatives Creed deployed at Taco Bell can serve as a blueprint for productivity improvements across the system. On the whole, we take a positive view of Yum's corporate governance, backed by a seasoned management team with a record of balancing growth and profitability. Senior executives and board members collectively own approximately 2% of the fully diluted outstanding shares, which is sufficient to align their interests with those of other shareholders, in our view. The firm has adopted several shareholder-friendly stewardship practices during the past several years, including the elimination of director classes and poison pills and the adoption of majority voting standards. Our Standard stewardship rating is based largely on underperformance in the United States and other developed markets, although we'd consider moving our rating to Exemplary if fundamentals in these countries continue to improve because of recent segment reorganization plans and

management changes.

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**Profile**

With 40,600 units across more than 125 countries as of September, Yum operates one of the largest global QSR systems based on number of units. It generates revenue through company-owned restaurants, franchise fees, and licensing arrangements. Concepts include KFC (19,000 locations), Pizza Hut (15,200), and Taco Bell (6,100). Yum generated \$43 billion in system sales in 2013 (19% China, 38% KFC, 23% Pizza Hut, 19% Taco Bell) and \$2.2 billion in operating profit before corporate expenses (35% China, 29% KFC, 15% Pizza Hut, 21% Taco Bell).

# Yahoo! Inc YHOO | ★★

\$51.74 ↑ \$5.69 | 12.36%

Fair Value Estimate	<b>\$42</b>
Consider Buying Price	<b>\$25.2</b>
Consider Selling Price	<b>\$65.1</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

09-18-2014 | by Rick Summer

## Analyst Note 10-22-2014

Yahoo's third-quarter earnings report benefited from improvements in several facets of the firm's core business, yet we are hesitant to suggest there is early evidence of a turnaround in the pursuit of next-generation digital advertising. The larger determinants of shareholder return, at least over the short term, will be the tax strategies the company is able to achieve to minimize cash tax payments for gains related to future liquidations of its investment in Alibaba Group. Based on the value of the company's media assets, we are maintaining our narrow moat rating. We also don't anticipate revising our \$42 fair value estimate at this time. Clearly, Yahoo's relevance to the digital advertising market is not improving, as revenue lags that of companies such as Google and Facebook. Management is encouraging investors to focus on emerging advertising categories (video, native, social, and mobile), which are growing in the double digits, rather than the declining desktop display revenue these business segments are cannibalizing. In total, Yahoo's turnaround is less obvious. Overall revenue (excluding traffic acquisition costs) rose 1.2%, as continued weakness in display (down 6% ex-TAC) was offset by relative outperformance in search (up 5.6% ex-TAC). Management revealed mobile revenue of more than \$200 million for the quarter, or nearly 20% of total revenue, a bright spot in the quarter. As a media property, Yahoo may be able to successfully gain audience on smartphones and tablets. Still, we remain concerned about Yahoo's lack of mobile assets, and its developer platform has less functionality than Apple's iOS store or the Google Play platform, in our view.

## The Thesis 09-18-2014

We believe that today's stock price is predicated on a robust valuation and successful exit of Yahoo's investment in Alibaba Group. Investors should be aware that a significant amount of Yahoo's enterprise value is tied up in its 35% interest of Yahoo Japan and resulting 16.3% interest in Alibaba Group holdings as well as cash from the IPO. Alibaba Group has ownership interests in privately held Taobao and Alipay, as well as publicly traded Alibaba.com. Because lack of control over these holdings as well as reinvestment risk, we do not believe its value can support a sound investment thesis. Yahoo may be able to turn around its core business, but the divide between possible and probable is wide. Marissa Mayer has been at the helm for more than a year, but declaring a successful turnaround is premature, in our view. We believe the company can improve its near-term fortunes, but Yahoo's longer-term positioning and durability of its advantages are unclear. Yahoo's large base of more than 800 million users is an important asset, but management must appropriately navigate several hurdles in order to effectively turn around its core business. First, although Yahoo's focus on display has been its strength, users and advertisers are spending more time and money on other websites like Facebook, a social networking giant. Second, while Yahoo's media properties including its homepage, Yahoo Sports, and Yahoo Finance are well suited to a desktop world, the company has done very little to connect mobile applications to its more traditional web experience. Yahoo has continued to lose market share in online advertising to other destination

sites such as Facebook and Twitter. Currently, Facebook is the most heavily trafficked website in the world. Furthermore, Facebook has been able to gather superior information about its users, which helps advertisers target their campaigns. Although this industry is still relatively nascent, we believe these efforts will shift offline dollars to social networking companies more rapidly than to more traditional firms dependent on display like Yahoo and AOL.

## Valuation

We are raising our fair value estimate to \$42 per share from \$39 in consideration of Alibaba Group's IPO. Our fair value estimate considers approximately \$11 per share for Yahoo's core business, with the balance represented by cash and its ownership interest in Yahoo Japan and Alibaba Group. It is important to note that we still believe we are at a distinct information disadvantage in valuing the interest in Alibaba Group, and we would be hard-pressed to encourage aggressive investment exposure to what is essentially a venture capital investment. Furthermore, corporate governance is a serious issue at Alibaba Group, and it's not apparent that Yahoo shareholders will ever receive a value that is close to Alibaba Group's current fair value. We expect revenue to grow in the single digits in 2014 and beyond. We also believe search revenue will grow at a rather pedestrian rate as well because we remain concerned about Yahoo's ability to drive search query volume. We expect overall revenue growth to average 5% over the next five years. We are encouraged that the new management team will instill greater discipline in managing operating expenses, although we expect a reasonably heavy investment period over the next couple of years in mobile applications.

## Risk

If the search partnership with Microsoft continues to underperform, advertisers may abandon placing ads in Yahoo's search property, leading to declines in revenues. Furthermore, if the relationship with Microsoft sours, it's not clear that Yahoo has any better options to support its search technology. Social networking sites like Facebook also represent a risk to Yahoo. If these sites are able to continue growing users and building tools for advertisers to selectively target large and specific demographic groups, Yahoo may quickly become an inferior place for advertisements. Additionally, Yahoo's mobile strategy is less than clear, and the company risks investing in several low-return projects. Lastly, financial interests in Yahoo Japan and Alibaba Group ultimately may be worth much less on an after-tax basis than the firm currently believes. As a private company, Alibaba Group is challenging to value. We have no information advantage relative to management of Yahoo or Alibaba Group in pricing this holding. Although we recognize the ultimate value of Alibaba Group could prove quite lucrative, there is a wide range of values that this interest may hold for Yahoo shareholders. With respect to Yahoo Japan, it will be challenging to unload this large of an interest without taking a discount or encountering a potential tax liability.

## Management & Stewardship

After several years of management turmoil and a decade of questionable board oversight, we think the company made several moves in 2012 that are more aligned with shareholders' interests. First of all, the majority of Yahoo's board of directors was replaced, including longstanding chairman Roy Bostock. Additionally, the company pursued a high-profile CEO, naming Marissa Mayer to the post. While we aren't convinced that her background will provide a long-term halo effect to the company's shares, we do believe she is quite capable as a manager, a motivator, and a recruiter for new talent. Mayer, a former Google executive, has served as CEO since July 2012. In her short tenure, she has appointed several hand-picked executives in an effort to improve company morale, enhance product development, and turn around its core business. It is too early to evaluate Mayer's performance, but several datapoints are positive, in our view. First of all, Mayer has stated that she believes the company will pursue small technology and product-based acquisitions rather than large transformative deals. We agree with this strategy and embrace her long-term view. However, even if Mayer's strategy is successful, we do not anticipate more positive financial results until 2014. The board also appointed

Ken Goldman as CFO in 2012. Goldman was CFO of Fortinet prior to joining Yahoo. With respect to Yahoo's ownership in Alibaba Group, the company's liquidity plan has successfully begun. Alibaba Group bought back half of Yahoo's interest, freeing up sufficient capital for Yahoo to return \$1.5 billion to shareholders through a stock repurchase program. The company plans to repurchase an additional \$1.5 billion in 2013 as well. Furthermore, we are encouraged that there are additional measures in place to monetize the remaining ownership interest in Alibaba Group over the next several years. There continues to be turmoil in the engineering, sales, and executive talent, and these changes product delays and sales challenges. Unlike the past turnover, we believe these changes are part of building cohesive team whereby everyone is pursuing the same strategy. As with many technology companies, employees have a significant amount of compensation in the form of stock options and restricted stock. A portion of these performance-based awards vest depending on certain financial goals and stock performance goals. We do not find these variable compensation practices overly concerning.

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**Profile**

Yahoo is one of the most heavily visited collection of websites on the Internet. Some of its more trafficked websites include Yahoo Search, Yahoo Mail, and Yahoo News. The company has undertaken significant effort to offload nonstrategic businesses and outsource the underlying search algorithm and operations to Microsoft. In 2013, display advertising represented 39% of total revenue, and search advertising represented 38%. Yahoo also owns 35% of Yahoo Japan and 16.3% of Alibaba Group.



# Health Care Select Sector SPDR® ETF

XLV | ★★★

\$69.61 ↑\$2.34 | 3.48%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$70.32000</b>
Fair Value Estimate	<b>\$</b>
Consider Buying Price	<b>\$</b>
Consider Selling Price	<b>\$</b>
ETF Expected Return	<b>0.00%</b>
ETF Hurdle Rate	<b>%</b>
ETF Expected Excess Return	<b>%</b>
Morningstar Coverage	<b>% of assets</b>
	<b>0 of 0 Holdings</b>
Stock Quality (as % of assets)	<b>% Wide Moat</b>
	<b>% Narrow Moat</b>
	<b>% No Moat</b>
Fair Value Uncertainty	

07-24-2014 | by Robert Goldsborough

## The Thesis 07-24-2014

### Suitability

Investors seeking high-quality North American health-care companies can consider Health Care Select Sector SPDR XLV. Given the sector's lack of economic sensitivity, investors seeking a defensive tilt for a broad portfolio may view this exchange-traded fund as a suitable satellite holding. XLV's holdings comprise all of the S&P 500's health-care exposure, so owning this ETF and SPDR S&P 500 SPY means investors effectively are doubling up on their health-care exposure. In July 2014, health care represented about 13.2% of the S&P 500 Index.

While XLV offers exposure to many industries in the health-care sector, Big Pharma firms comprise 45% of the fund's assets. XLV's heavy Big Pharma exposure shouldn't by itself deter investors, however, as the subsector weightings are representative of the entire health-care industry.

### Fundamental View

Historically defensive and noncyclical, the health-care sector is gaining added growth from an aging America. Demand is relatively stable because people require treatment regardless of the economy, and the need among approximately 78 million baby boomers in the United States for greater treatment makes for a compelling secular growth story. An aging population bodes well for the industry's future prospects because the majority of people's lifetime medical costs are spent in their final few years.

The biggest development in the health-care sector of late has been the opening of state-based health-care exchanges, which allow individuals and small businesses to purchase standardized health-insurance policies, receive government subsidies to offset premiums and cost sharing, and determine Medicaid eligibility. While U.S. health-care reform introduced new costs for several industries, Morningstar's equity analysts believe that several health-care subsectors are poised to benefit from the exchanges: health-care providers (although the magnitude of benefit is uncertain), managed-care organizations that already have economic moats, pharmacy benefit managers (who may well be the biggest beneficiaries), and pharmaceutical companies (especially generics). Medical-device manufacturers are not expected to see any measurable boost from the exchanges.

Elsewhere in the health-care sector, Morningstar's equity analysts see two headwinds and one potential tailwind. The headwinds are problems in Europe and an uncertain impact from sequestration in the U.S. Even Medicare--once viewed as a sacred cow that would never be subject to cuts--is now at risk of undergoing structural changes. One tailwind is the rebounding pharmaceutical industry. Big Pharma growth rates are bouncing back after patent losses peaked in 2012, and competition is starting to dissipate. Pharmaceutical firms released a huge number of blockbuster drugs in 2013 and have released a significant number more in 2014, and also will benefit from cost-cutting, external growth, and overseas growth.

The aging of China offers a medium- and long-term opportunity for U.S. health-care firms. As the country ages and becomes wealthier, Morningstar's equity analysts anticipate the country to start moving the needle for large U.S. players in a variety of subsectors, including pharmaceuticals and medical technology. Right now, China spends about 5% of GDP on health care, which is far below the global average of 10% but commensurate with what one might expect for its income level. As incomes rise and China's population ages, we expect China's health-care market to grow to \$1.7 trillion in 2022. That means the growth potential for Chinese health-care spending is far greater than that for GDP. Assuming a normal path as China grows richer and older, health care's share of Chinese GDP should grow by 40% by 2022. (China's market for health products and services currently is roughly the same size as that of Germany and France combined.) For this growth to take place, China needs to continue to spend on its health-care infrastructure, with the central and local governments expanding spending on hospitals. One other current issue in China relates to corruption, as there have been recent bribery scandals in the pharmaceutical and the medical-device industries. Chinese authorities have begun taking steps to tighten up practices in the pharmaceutical space, and we expect them to do the same with the device firms as well.

The health-care sector outperformed other sectors nicely in 2013 and for the first six months of 2014. Our view is that the investment community understands the various sector headwinds but nonetheless has settled on a positive long-term outlook. That said, our analysts also consider the sector to be largely fairly valued at this time with a few exceptions, most notably in pharmacy benefit managers.

## Fees & Alternatives

The fund's 0.16% expense ratio makes it one of the cheaper health-care sector ETFs available.

### Alternatives

Vanguard Health Care ETF VHT provides similar exposure to the sector (but it has many more holdings: 312 in total) and charges a 0.14% expense ratio. Fully 100% of XLV's holdings are held in VHT, and the funds' performance correlation during the past five years has been an extremely high 99%. Another alternative is iShares U.S. Health Care IYH (0.43% expense ratio), which holds 109 stocks and sports a 99% performance correlation with XLV during the past five years.

A recently launched and inexpensive option is Fidelity MSCI Health Care Index ETF FHLC, which charges 0.12%. However, FHLC has minimal assets and is thinly traded. FHLC tracks a slightly different index from Vanguard Health Care ETF; FHLC tracks the MSCI USA IMI Health Care Index, while VHT tracks the MSCI US Investable Market Information Health Care 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FHLC commission-free, although they are subject to a short-term trading fee by Fidelity.

Investors seeking some international flavor for their health-care exposure can consider iShares Global Healthcare IXJ (0.47%), as it invests 37% of assets in foreign-domiciled firms. Those seeking exposure only to those firms domiciled outside North America might take a look at SPDR S&P International Health Care Sector ETF IRY (0.50%).

## Portfolio Construction

This ETF owns the 53 health-care companies in the S&P 500, weighted according to market cap. These include firms focused on drugs (both Big Pharma and biotech), health-care equipment and supplies, hospitals, medical devices, and health insurers.

Because the index draws its constituents from the broader S&P 500, it has an inherent quality screen. In fact, seven of the top-10 holdings sport wide moat ratings. About 66% of assets are invested in wide-moat stocks, and 96% of assets are invested in companies with narrow or wide moats. S&P 500 holdings have to meet the standards of the S&P's selection committee, and this includes profitability and status as a leading U.S. company. Because the criteria eliminate foreign health-care companies, the index excludes international health-care behemoths such as Novartis NVS, GlaxoSmithKline GSK, Roche, and Sanofi SNY. That said, we'd note that most of the firms included here are large multinational firms with businesses spanning the globe.

# Materials Select Sector SPDR® ETF

XLB | ★★★★★

\$49.16 ↑\$0.76 | 1.57%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$49.6600</b>
Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
ETF Expected Return	<b>9.96%</b>
ETF Hurdle Rate	<b>16.69%</b>
ETF Expected Excess Return	<b>-6.73%</b>
Morningstar Coverage	<b>89.11% of assets</b>
	<b>28 of 31 Holdings</b>
Stock Quality (as % of assets)	<b>16.61% Wide Moat</b>
	<b>45.84% Narrow Moat</b>
	<b>26.51% No Moat</b>
Fair Value Uncertainty	<b>High</b>

09-29-2014 | by Alex Bryan

## The Thesis 09-29-2014

### Suitability

Materials Select Sector SPDR XLB is currently the most-liquid materials exchange-traded fund on the market. It owns every materials company included in the S&P 500 Index. This includes companies operating in the chemicals, metals and mining, paper and forest products, containers and packaging, and construction materials industries. Most of these companies sell into commodity markets and are susceptible to cyclical demand. They also have to contend with volatile raw-material and energy prices and high fixed costs. The fund's concentrated portfolio adds to these operational risks. As a result, during the past five years, XLB was about 50% more volatile than the S&P 500. Because of its industry concentration, this fund would be most suitable as a tactical holding in a diversified portfolio.

The fund invests in an eclectic mix of companies, including Monsanto MON, Freeport-McMoRan Copper & Gold FCX, industrial gas companies Praxair PX and Air Products & Chemicals APD, as well as global metals producers Alcoa AA and Nucor NUE. But this is primarily a chemicals fund. In fact, chemicals companies soak up nearly 75% of the fund's assets. This is because most of the low-cost metals and mining and other commodity producers are based outside of the United States. Investors looking for broader exposure to this sector should consider a global materials fund such as iShares Global Materials MXI.

Chemicals companies' products are found nearly everywhere. They are incorporated into plastics, paints, homes, electronics, cars, petroleum, industrial gas, coatings, fabrics, and agricultural products, among others. Consequently, demand for these products is cyclical. Yet, some of the fund's top holdings enjoy competitive advantages that partially insulate their profits from this cyclical demand. The most durable competitive advantages in the chemicals industry are built around specialty products and access to low-cost inputs. Fund holdings Monsanto, DuPont DD, and PPG Industries PPG have built competitive advantages by moving up the value chain into more-specialized, higher-margin products. However, wide moats are scarce in this industry.

### Fundamental View

The shale gas boom has reduced feedstock costs for North American chemical

producers relative to chemical manufacturers in Europe, which are more dependent on higher-cost naphtha (a heavy crude-based feedstock). However, industry margins could contract as chemical producers continue to add new capacity. Cyclical demand also poses a challenge. In order to reduce the volatility of their earnings, some of the fund's chemicals holdings are shifting toward less-cyclical, higher-margin specialty products, though most are still dependent on cyclical basic chemicals. DuPont and Dow Chemical DOW are taking steps to divest a portion of their commodity chemicals businesses. These two companies have also developed significant agricultural chemicals and genetically modified seed businesses to reduce their dependence on commodity chemicals.

The fund also has significant exposure to the agricultural industry through pure-play agriculture chemical and seed maker Monsanto and fertilizer makers Mosaic MOS and CF Industries CF. Crop prices can have a significant impact on demand for yield-enhancing seeds, chemicals, and fertilizer in the short term because farmers' incomes are closely tied to them. But ultimately, these firms' ability to stay ahead of their competitors in the race to meet the growing demand for food will drive their performance. Growth in global population and meat consumption in emerging markets will require agricultural output to increase substantially over the next few decades, according to projections from the Food and Agricultural Organization. Because the amount of arable land is relatively fixed, these long-term trends likely will increase demand for yield-enhancing products.

Chinese infrastructure development has a significant impact on the demand for industrial metals. However, Chinese demand for industrial metals may soften over the long run, as the country starts to shift away from its investment-driven growth model.

The Chinese real estate market is starting to show signs of weakness, with an 11% year-over-year decline in housing starts for the period January through August and a 9% decline in commercial building sales. According to Morningstar equity analysts, prices have fallen in most of China's major cities and may remain soft in the face of a supply glut and weakening demand. That could be bad for iron and copper prices and the companies that mine them because the Chinese real estate market accounts for a large portion of global demand for those metals.

Gold miners, such as Freeport-McMoRan and Newmont Mining Corporation NEM, also face a challenging operating environment. Gold prices have receded from record highs, as costs remain elevated. While the outlook for the industry is not promising, metals and mining stocks only represent about 13% of the portfolio.

Based on Morningstar equity analysts' fair value assessments of the funds' underlying holdings, it is trading at a price/fair value multiple of 1.04, as of this writing. Because its holdings face significant risks, it might be worthwhile to wait until the fund trades at a discount to its fair value before buying. As of the end of August, the fund was trading at a slightly higher price/forward earnings ratio (19.1) than the S&P 500 (17.5).

## Fees & Alternatives

The fund's 0.16% expense ratio is low relative to comparable materials-sector ETFs. It is also by far the most liquid materials-sector ETF available. State Street engages in securities lending, the practice of lending out the fund's underlying shares in exchange for a fee. It passes 85% of the gross proceeds to investors, which partially offsets the fund's expenses.

### Alternatives

Vanguard Materials ETF VAW (0.14% expense ratio) and iShares US Basic Materials IYM (0.46% expense ratio) are the closest alternatives. Both VAW and IYM climb further down the market-cap ladder to offer broader portfolios. Because small-cap companies in this sector tend to lack many of the competitive advantages their large-cap counterparts enjoy, they tend to be more volatile. As a result, VAW and IYM gave investors a slightly bumpier ride than XLB over the past three years. However, the Vanguard fund is a worthy option for investors looking for comprehensive exposure to the sector. Because of its high expense ratio, we would stay away from IYM.

Investors looking for more balanced exposure to the materials sector might consider iShares Global Materials MXI (0.48% expense ratio). In contrast to XLB, MXI invests in both U.S. and non-U.S. materials stocks. MXI's global reach allows it to hold many

of the industry leaders in the metals and mining industry that are not available to XLB. Consequently, relative to XLB, MXI offers greater exposure to the metals and mining industry and less exposure to the chemicals industry.

Investors looking for broad commodity-linked equity exposure might also consider a natural-resources fund, such as SPDR S&P Global Natural Resources ETF GNR (0.40% expense ratio). GNR tracks the 90 largest stocks from around the world in the energy, agriculture, and metals and mining industries.

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### **Portfolio Construction**

The fund employs full replication to track the S&P Materials Sector Select Index, which includes all 30 materials companies in the S&P 500 Index. It weights these holdings in proportion to their float-adjusted market capitalization. S&P limits individual positions to 23% of the portfolio, though the fund's largest holding falls well below that mark. Chemicals companies represent approximately 75% of the portfolio, followed by metals and mining (13%), containers and packaging (6%), paper and forest products (3%), and construction materials companies (3%). Because of its limited number of holdings, the portfolio is highly concentrated. The top 10 holdings soak up more than 65% of the fund's assets. However, the materials sector represents a small sliver of the U.S. stock market. In fact, the fund's holdings account for less than 4% of the total assets in the S&P 500 Index.

# Southern Co SO | ★★★

\$47.43 ↑\$1.07 | 2.31%

Fair Value Estimate	<b>\$46</b>
Consider Buying Price	<b>\$36.8</b>
Consider Selling Price	<b>\$57.5</b>
Fair Value Uncertainty	<b>Low</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Exemplary</b>

11-19-2014 | by Mark Barnett

## Analyst Note 12-03-2014

We visited the Southern Company's Vogtle nuclear site in Georgia this week to tour the two new reactors being built there. We are reaffirming our \$46 per share fair value estimate and stable narrow moat rating for Southern, and don't expect to make any changes to our financial forecast for the company for now. The reactors are concurrently under construction. The first of them, Unit 3, is just beginning to take shape aboveground. As management has previously disclosed, there have been difficulties trusting the quality assurance from contractor CB&I's Lake Charles facility and in receiving some of the large modules on time. We saw firsthand how large Southern's own QA triage at the site is, and we consider it an extremely prudent step that management has taken. There is still much work to finish, and delays from the planned fourth-quarter 2017 and fourth-quarter 2018 start seem inevitable. It's critical to remember that outside of owner's costs, higher costs due to materials and equipment issues are the responsibility of the contracting consortium under the terms of Southern's contract. While this could take time to resolve in the event of such a revision, we expect that management's strong negotiating position will help mitigate the impact on ratepayers and investors. This has already been demonstrated in our view with the dispute over \$900 million in costs around engineering design issues that led to dual lawsuits. While the suit is far from being resolved, jurisdiction for hearing was placed in Georgia, not Washington, D.C. Whatever the resolution of this case or further cost overruns due to equipment and materials, the final review will take place after the reactors are placed into service, reducing regulatory risk in the near term. For investors, cost escalation due to delays is mitigated by ongoing collection of finance costs which in turn are mitigated by the \$3.5 billion DOE loan guarantee Southern received for the project.

## The Thesis 11-19-2014

Southern's total return proposition remains appealing for patient investors in a world of few decent income alternatives. This giant Southeast utility enjoys some of the best regulation in the United States and strong, consistent regulatory relationships in its key service territories of Alabama and Georgia. The company is in the middle of a huge investment program aimed at phasing out or retrofitting its massive coal fleet, building a low-carbon coal unit in Mississippi, and constructing the first new nuclear plant in the U.S. (in Georgia) after a more than 30-year freeze. While regulatory risk is high--as evidenced by ongoing cost disputes in Mississippi and cost overruns at Vogtle's peer nuclear project in South Carolina--earnings and cash flow growth should improve as expenditures close to rates, driving just under 4% earnings and dividend growth through 2018. Although economic growth in the firm's four service territories might not remain above average, capital investment remains the primary engine of our growth forecast, and much of it closes to cash returns annually, keeping cash lag below many peers'. Southern has more upside to economic improvement than most peers and has traditionally traded at a premium to the sector. While that premium has shrunk with uncertainty around Kemper and Vogtle, investors shouldn't underestimate Southern's constructive regulatory structure,

despite above-average recovery risk during this investment cycle. Favorable and supportive regulation is a key driver behind the company's huge construction program and above-average returns.

## Valuation

We are raising our fair value estimate to \$46 per share from \$45 to account for the time value of money since our last update and incorporating third-quarter results, the increase in Kemper charges, management's new capital expenditure guidance through 2016, and updates to our power demand forecast. We continue to include a 75% chance that Southern settles with Chicago Bridge & Iron on the Vogtle cost dispute, assuming shareholders could bear roughly \$300 million in a settlement. We also include an incremental \$200 million in cost overruns at Kemper and \$200 million in owners' costs at Vogtle. However, it's possible that Southern could pass any settlement costs to customers or win a fully litigated case in court, neutralizing the impact on investors. Year-to-date usage strength has been strong due to favorable weather, which could continue with a cold winter, bringing in extra cash above our forecast. Our forecast for total capital investment through 2018 is roughly \$24 billion and incorporates expenditures to meet coal plant emission limits in the federal air toxics rule and revised costs for the Kemper plant and Vogtle project. We forecast this spending can deliver 4.5% average annual EBIT growth through 2018. We expect Southern's regulated utilities to continue earning near its industry-leading allowed returns, though we project modest declines in allowed returns on equity through the current rate cycle. We forecast 7.9% average ROIC during the next five years. We forecast average power demand growth of just below 1.5% for Southern's utilities from a strong start to 2014 through 2018. During the next five years, we assume consolidated operating margins average 26%. We anticipate Southern will increase its dividend 3.5% annually during the next few years, largely in line with management's projections. We use an 8% cost of equity and 5.7% weighted average cost of capital in our discounted cash flow valuation.

## Risk

Although we are bullish on this company's prospects overall, some uncertainties remain, including the impact of nuclear cost overruns, possible emissions legislation, and other fossil fuel regulations. However, compliance measures could prove to be less painful to shareholders than some might expect; regulators will allow Southern to pass most of the incremental costs on to customers, preserving the firm's long-term earnings power. The biggest threat that Southern faces is a deterioration of its regulatory relationships in its four retail service territories. Much of the company's success hinges on the relationships it has built through years of low power prices and excellent customer service. While the Kemper facility has been a financial setback, we don't believe it has any long-term impact on Southern's regulatory relationships in Mississippi and certainly not elsewhere. The risk of declining customer usage has increased, although Southern's best-in-class regulation should help mitigate the effects. Nuclear construction expenses are approved twice a year, but there is still a risk that additional expenses might not be recovered. Cost overruns could also lead to further stranded capital at the new coal gasification plant or at the new nuclear plants, though a revised process in Georgia eases the burden of approval for new costs. If tough federal environmental regulations further raise investment needs and costs for customers, regulators might be less willing to support above-average allowed returns on equity.

## Management & Stewardship

Southern's management team historically has comprised highly capable and conservative individuals. Many high-level executives running other utilities trace their roots to Southern. Management has fostered excellent regulatory relations in its service territory, but that didn't stop Southern from joining in the foolishness of expanding beyond regulated operations like so many of its peers in the late 1990s. The company's eventual spin-off of troubled subsidiary Mirant in 2001 was a nice feat of timing before the Enron collapse. Since then, management has operated Southern's nonregulated business very conservatively, earning returns on capital in line with its regulatory allowed returns. CEO Thomas Fanning served as CFO and COO

of Southern as part of his 30-year tenure with the company before his promotion in late 2010. He has executive experience as well, having served as president and CEO of Gulf Power. Importantly, management has maintained a focus on preserving goodwill and constructive exchange between its utilities and its state regulators, which we believe is a crucial driver of utility returns over the long run.

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**Profile**

Southern generates and distributes electricity to more than 4.4 million customers in the Southeast. It owns four electric utilities in Alabama, Georgia, Florida, and Mississippi and has more than 45,500 megawatts of generating capacity, nearly half of which comes from coal-fired plants. Southern also operates a conservative but growing merchant generation segment, Southern Power.



# Consumer Staples Select Sector

## SPDR® ETF XLP | ★★★

\$49.30 ↑\$2.59 | 5.54%

ETF Valuation Rating (as of 12-04-2014)	
ETF Market Price (as of 12-04-2014)	<b>\$48.8000</b>
Fair Value Estimate	\$
Consider Buying Price	\$
Consider Selling Price	\$
ETF Expected Return	<b>6.55%</b>
ETF Hurdle Rate	<b>9.25%</b>
ETF Expected Excess Return	<b>-2.70%</b>
Morningstar Coverage	<b>97.71% of assets</b>
	<b>38 of 41 Holdings</b>
Stock Quality (as % of assets)	<b>70.38% Wide Moat</b>
	<b>18.76% Narrow Moat</b>
	<b>8.27% No Moat</b>
Fair Value Uncertainty	<b>Medium</b>

08-14-2014 | by Robert Goldsborough

### The Thesis 08-14-2014

#### Suitability

Consumer Staples Select Sector SPDR is suitable as a complementary satellite holding to a diversified portfolio. This exchange-traded fund, which offers exposure to mega-cap household names whose products consumers generally continue to buy regardless of the economic climate, could also be viewed as a defensive portfolio tilt. Food and staples retailers make up 25% of this ETF's assets, followed by household products firms (20%), beverage producers (19.5%), food producers (18%), and tobacco companies (15%). This fund has been 75% correlated with the S&P 500 during the past five years.

During the past 10 years, this ETF has been meaningfully less volatile than the broader market. It also has displayed less volatility than competing consumer staples ETFs. The fund is less volatile because unlike iShares US Consumer Goods IYK, XLP holds Wal-Mart WMT and several other large, defensive drug and discount retailers. These relatively steadier names have helped mitigate XLP's volatility. In addition, unlike one other competing staples ETF, XLP does not hold any auto-related firms, which generally are far more volatile.

#### Fundamental View

In general, consumers buy consumer staples products and services regardless of the economic climate. As a result, the holdings in this ETF generally have stable revenue growth and cash flows.

During the past year, the market performance of the U.S. consumer staples sector has lagged many other U.S. equity sectors. The two biggest contributors, we believe, are the recent slowdown in consumer spending in emerging markets (which are a perceived growth catalyst for many consumer staples companies) and some general concerns about the U.S. consumer. Most recently, some staples firms with strong overseas sales have been facing foreign-currency headwinds that have had negative impacts on reported quarterly operating profits. That said, Morningstar's equity analysts are relatively optimistic about consumer staples firms' prospects in emerging-markets economies over the long run.

Food and staples retailers comprise 25% of this ETF. XLP's largest retail holding is Wal-Mart WMT, which has been reinforcing its everyday-low-price strategy through

major price cuts and is making better capital-allocation decisions, such as shifting its capital toward higher-return domestic small stores, instead of lower-return foreign ones. However, Wal-Mart has a Negative Moat Trend from Morningstar's equity analysts, as it is facing greater competition from Costco COST and Amazon.com AMZN, both of which have lower fixed-asset bases and are willing to run their businesses at lower margins. (Amazon, which is not held in this ETF, also has begun competing in the online grocery space in California, and our equity analysts believe that the rollout of this service across major urban centers in 2014 could be a key turning point in the evolution of online grocery sales.) Wal-Mart's small-store expansion may well cut into pure-play grocers held in this ETF, such as Safeway SWY and Kroger KR. Finally, drug retailers held in this ETF, such as CVS Caremark CVS and Walgreen WAG, over the longer term stand to benefit from health-care spending growth and an aging population, although their success in the nondrug portions of their stores is less certain.

Tobacco companies, which make up around 15% of this fund's assets, have long been under pressure from increased government regulations, including requiring greater marketing restrictions, and higher taxation. Companies' more mature markets are experiencing lower cigarette demand, but their Asian operations are expected to be an engine for future growth. Philip Morris International PM in particular has a well-balanced portfolio between developed and emerging countries; it is the dominant player in the European Union and has a leading position in much of Eastern Europe, the Middle East, Africa, and Asia. Unit volumes for Philip Morris are expected to rise in the coming decade in overseas markets such as Asia, Africa, and Eastern Europe, where populations are growing and there are looser restrictions on tobacco marketing. In the short term, however, we do expect weakening emerging-markets currencies to provide a stiff headwind to the company's financial results. Other tobacco companies held in this ETF, such as Altria MO and Reynolds American RAI, are more focused on the declining U.S. market. And while CVS will cease selling cigarettes and tobacco products across its 7,600 U.S. stores by October 2014, convenience stores and gas stations--both of which are fragmented markets--comprise the bulk of U.S. cigarette sales. So even if other pharmacies such as Walgreen and Rite Aid RAD follow suit, tobacco should remain widely available for adults to purchase.

Commodity costs and consumer staples firms' ability to extract pricing from consumers are something to monitor in this sector. Recently, inflation has been fairly minimal, which has meant that pricing has been a bit more muted. Even so, some consumer staples firms, such as McCormick MKC, Hershey HSY, and Clorox CLX, have been able to make price increases stick. In fact, in response to higher input costs, Clorox has made 66 price increases since 2005, and Morningstar's equity analysts have noted that 64 of those are still in place. So some firms held in this ETF are able to extract pricing from consumers, albeit with an occasional lag.

Consumer staples ETFs' dividend yields typically are in the 2.7%-3.1% range, which is slightly higher than that of the S&P 500 Index. Morningstar's equity analysts believe that ultralow interest rates have been helping to fuel the valuations of the consumer staples sector as a whole, with many investors stretching for yield. As a result, our analysts caution that rising rates could revise investors' required returns upward, detracting from total returns on consumer staples stocks, despite steady dividend payments and earnings growth.

Although some merger and acquisition activity has been taking place in the sector (most recently, Tyson Foods' TSN plans to acquire Hillshire Brands HSH), investors also should pay close attention to recent pressures that consumer staples companies have been facing to split apart, in an effort to drive better focus, share gains, and ultimately earnings growth. Potential breakup targets include Unilever UN, Nestle NSRGY, Procter & Gamble PG, and PepsiCo PEP.

### Fees & Alternatives

The fund's 0.16% expense ratio is the second-lowest expense ratio of any large and liquid ETF in its category. XLP's estimated holding cost is slightly higher at 0.21%. Estimated holding costs are primarily composed of the expense ratio but also include transaction costs, sampling error, and share-lending revenue.

#### Alternatives

Investors seeking nondiscretionary exposure to the consumer have plenty of ETF

choices. The most similar alternative to XLP is the smaller and less-liquid Vanguard Consumer Staples ETF VDC (0.14% expense ratio). XLP holds just 40 stocks versus VDC's 106, but the two ETFs show almost perfectly positively correlated performance during the past five years (99%). In terms of assets under management and average daily trading volumes, XLP dwarfs VDC. Thus, large institutional investors demanding deep liquidity in order to move in and out of positions without having a market impact might favor the greater liquidity of XLP or might consider working with an ETF liquidity specialist. However, in our view, VDC still offers sufficient liquidity for individual investors.

XLP and VDC have very similar subsector weightings and in fact have the same top-10 holdings. However, XLP tilts slightly more toward large-cap companies (88% of assets versus 82% of VDC's assets). Probably the biggest difference between the two ETFs is one of concentration--XLP's index assigns heavier weightings to its largest holdings than VDC's index does.

Another option is iShares US Consumer Goods IYK (0.43% expense ratio), which offers very similar exposure but excludes the major retailers held by VDC and XLP. Unlike XLP and VDC, IYK also holds auto manufacturers such as Ford F and some apparel companies not found in other consumer staples ETFs, such as Nike NKE. A recently launched and very inexpensive option is Fidelity MSCI Consumer Staples Index ETF FSTA, which charges 0.12%. However, FSTA has minimal assets and is thinly traded. It tracks a slightly different index from Vanguard Consumer Staples ETF; FSTA tracks the MSCI USA IMI Consumer Staples Index, while VDC tracks the MSCI US Investable Market Consumer Staples 25/50 Index. Fidelity customers with a minimum balance of \$2,500 can buy FSTA commission-free, although they are subject to a short-term trading fee.

Those interested in gaining exposure to international consumer staples titans can consider iShares Global Consumer Staples KXI (0.47% expense ratio). KXI consists almost entirely of food and beverage producers and large European retailers.

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### Portfolio Construction

A market-cap-weighted ETF, XLP invests in the consumer staples stocks of the S&P 500 and employs a cap-weighted structure. Sticking to S&P 500 companies provides an initial screen for quality, as holdings must meet the standards of S&P's selection committee. In fact, some 70% of XLP's assets are invested in wide-moat firms, and 19% are allocated to firms that Morningstar's equity analysts deem as having narrow economic moats (Morningstar's equity analysts define economic moats as durable competitive advantages). Constituents usually have to be leading U.S. companies that meet S&P's profitability criteria. The criteria eliminate large international companies, including Unilever and Diageo DEO. XLP holds 40 companies.

Consumer staples ETFs track indexes that are labeled either "consumer staples" or "consumer goods." Both types of indexes contain food producers, beverage companies, tobacco firms, and personal-goods firms. However, consumer staples indexes--and by extension, the ETFs that track them--contain food and drug retailers, as well as Wal-Mart, while consumer goods indexes do not. Similarly, consumer goods indexes contain automakers, automotive retailers, and auto components manufacturers, while consumer services indexes do not.

# Molson Coors Brewing Co TAP | ★★

\$77.35 ↑\$2.97 | 3.99%

Fair Value Estimate	<b>\$67</b>
Consider Buying Price	<b>\$46.9</b>
Consider Selling Price	<b>\$90.45</b>
Fair Value Uncertainty	<b>Medium</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Standard</b>

11-18-2014 | by Adam Fleck

## The Thesis 11-18-2014

Molson Coors enjoys strong market positions in its Canadian, U.S., and Western European markets (which we estimate together contribute 95% of volume), and is investing to increase its exposure to higher-growth areas. While we think brand intangible assets will protect long-run returns on invested capital, we believe the company's moat is constrained to narrow given secular challenges to mainstream beer volume growth and lower economies of scale versus larger, wide-moat brewers. Molson has solid brand names (e.g. Coors and Miller) in its primary markets. The company is the second-largest brewer in Canada and the U.S. (the latter through its MillerCoors JV with SABMiller), trailing only Anheuser-Busch InBev in both cases. Molson is also a strong participant in Western and Central Europe with about 21% market share. While we expect pricing in these geographies to remain rational given concentrated market positions, mainstream beer volumes suffered over the past several years due to a shifting consumer preference toward spirits, wine, and higher-end craft brews. MillerCoors holds some exposure to craft beers through its Tenth and Blake division (with brands such as Blue Moon and Leinenkugel), but the small size of this business--a single-digit percentage of revenue--mutes our optimism. Molson Coors acquired Central European brewer StarBev in 2012, but has failed to reinvigorate sales velocity; total European segment hectoliters were roughly flat in 2013. Still, this is partly due to severe regional flooding that limited consumption, and we expect growth to rebound given rising per-capita incomes and increasing prices. In all, Molson Coors and MillerCoors generate lower operating profits than industry behemoths AB-InBev and SABMiller. Although MillerCoors has enjoyed solid cost control and resulting operating profit expansion, Molson's other segments have seen profitability stagnate in recent years. Given Molson Coors' lower volume (including proportional ownership in MillerCoors, about 61 million hectoliters in 2013, compared to 307 million for SABMiller and 426 million at AB-InBev), we don't expect this margin gap to close in the foreseeable future.

## Valuation

After transferring coverage to a new analyst, we've increased our fair value estimate to \$67 from \$57. Our updated valuation implies a 15.3 times multiple to our 2015 earnings per share estimate, and a 9.6 EV/EBITDA (both including Molson Coors' 42% ownership in U.S. subsidiary MillerCoors). We evaluate the value of Molson Coors and MillerCoors separately, and estimate that the firm's ownership in MillerCoors makes up about two-thirds of the total value. For this business, we expect volumes to remain relatively muted in the low-single-digit range, stemming from a continued secular trend away from beer in general, and away from value and premium beer (such as Coors and Miller Lite) in particular, offset by MillerCoors' growing exposure to the craft brew market. We forecast sales growing at a bit higher 3% clip, however, due to rational pricing within the marketplace. Moreover, we expect relatively flat operating margins given the substantial manufacturing and administrative costs already removed from the system; we expect long-run operating margins at about 16.5%, roughly in-line with 2013 levels. For Molson Coors'

remaining businesses, we similarly expect minimal volume growth but low-single-digit price gains. We expect the fastest growth in the firm's international segment (in the high-single-digit range), but at just 3% of sales, these regions (primarily India, Japan, and China) will probably have a minimal impact on the overall business. The remaining 97% of sales is comprised of Europe (about 50% of consolidated sales) and Canada (47%); we expect a bit faster growth in the firm's European segment given exposure to higher-growth Central and Eastern regions, which should enjoy rising per-capita GDP and resulting higher beer volumes and more-premium pricing. Operating margins at Molson Coors excluding MillerCoors have averaged about 12% over the past five years, but have slipped in recent years, and finished 2013 at roughly 11%. Nonetheless, we expect improving cost positioning, better volume growth, and price increases to drive long-term margins back to the 12% level. We use a 8.7% weighted average cost of capital (comprised of a 10% cost of equity and 6% cost of debt) to discount our estimated free cash flow for Molson Coors, and an 8% WACC (8% COE, with minimal debt) for MillerCoors; we use different costs of equity given Molson Coors' exposure to higher growth, but higher-risk, emerging markets, and MillerCoors' overall loftier profitability.

## Risk

If the economic conditions in Molson Coors' markets were to worsen and unemployment rises, the firm could lose volumes. For example, in the global financial crisis young males were disproportionately affected. These consumers are the primary demographic for the firm's value and premium brands, which caused volumes to suffer. Alcohol is heavily taxed in all of Molson Coors' markets. If one these governments were to increase taxes (which are often passed to consumers) or enact other policies to reduce beer consumption, the firm's volumes would likely suffer. Finally, there has been significant consolidation in the beer industry recently. Molson Coors could overpay for an acquisition in the future or see the competitive landscape shift quickly as large brewers buy smaller players.

## Management & Stewardship

We believe Molson Coors' management team has been standard stewards of shareholders capital. Management has made some wise strategic decisions, such as the MillerCoors JV. However, it has also made some significant missteps such as the Kaiser acquisition in Brazil. Also, while the long-term outcome of the recent StarBev acquisition is unknown, the firm recently had to write off over 10% of the acquisition's value due to brand impairments. Given our view that shares are overvalued we appreciate management's decision to keep the dividend but suspend buybacks (which we view as value-destructive at current valuation levels) as it attempts to bring down leverage from the StarBev acquisition. Looking at corporate governance, the firm is considered controlled by the New York Stock Exchange, meaning it is exempt from independent director minimums. Currently, the Molson and Coors families own the majority of A shares, which carry more voting rights than B shares. This arrangement leaves minority shareholders with little influence over the company's direction; only 3 of 15 board members are elected by minority owners. The families make up a significant amount of the company's board and the Molson Coors' bylaws state that chairman and vice chairman roles alternate between the families every two years. Although Molson Coors has just a 42% economic interest in the MillerCoors JV, it has 50% voting control. The JV's bylaws would allow Molson Coors to purchase up to a 50% interest and appoint the CEO in perpetuity should there be a change of control at SABMiller. Additionally, neither company can make a hostile overture to the other until 2018. However, since July 2013, either party can transfer its economic or voting interests in MillerCoors to another party as long as the other party maintains the right of first refusal.

## Profile

Molson Coors is a large global brewer. Major brands include Coors Light, Molson Canadian, Staropramen, Carling, Miller Lite, Keystone, Blue Moon, and Leinenkugel. The firm's largest markets include Canada, the United States, Central and Eastern Europe, and the United Kingdom. Molson Coors retains 39% share of the Canadian beer market, 28% of the U.S. beer market (via its MillerCoors JV with SABMiller),

and 21% of the European beer market.

# Coach Inc COH | ★★★★★

\$37.12 ↑\$2.74 | 7.97%

Fair Value Estimate	<b>\$45</b>
Consider Buying Price	<b>\$27</b>
Consider Selling Price	<b>\$69.75</b>
Fair Value Uncertainty	<b>High</b>
Economic Moat	<b>Narrow</b>
Stewardship Grade	<b>Exemplary</b>

10-28-2014 | by Paul Swinand

## The Thesis 10-28-2014

Coach has developed a narrow economic moat through a brand that enables pricing, sourcing and distribution advantages, and capital efficiency. Despite the company's recent struggles, it is still creating economic profits, and at a level greater than most retailers. Attention to capital efficiency and consumers' strong brand loyalty have been key drivers of Coach's economic returns. We judge brand to be more important in bags and leather accessories than other softgoods categories as consumers tend to be more brand-loyal. Despite Coach's long-run plans to increase penetration in footwear and ready-to-wear, we believe accessories will remain the core of the business. The men's business also offers some upside; it currently constitutes around 14% of sales. Coach's international business is still underdeveloped and represents an opportunity if growth there can continue for the long run. Although fiscal 2013 and 2014 struggles highlight Coach's market concentration in North America, using long-run success in Japan as a guide, we think there is plenty of room for Coach to take market share in other geographies. In Japan, Coach has had flat to low-single-digit growth for the past 10 years while competitors generally have experienced declines. The company entered Europe in 2012 through department store partnerships and is now penetrating further wholesale accounts and opening retail stores. We believe there is room for a brand such as Coach offering uniquely American styles and high-quality products at lower price points. In China, Coach lags other luxury brands with respect to sales, but has greater growth potential. The company increased its China business to more than \$100 million in 2010 and approximately \$550 million in fiscal 2014. Coach should also see higher operating margins in China as it expands because of lower operating costs and higher gross margins. In Europe, where Coach has just a small number of boutiques and is developing dedicated shops in department stores, the company should leverage selling, general, and administrative expenses over time and now projects \$100 million in revenue in fiscal 2015.

## Valuation

Our fair value estimate remains \$45 per share, as we have incorporated fiscal first-quarter results and management's reiteration of full-year guidance for low-double-digit revenue declines and high teens operating margins. Our fair value estimate implies 18 times forward fiscal June 2015 year-ending earnings per share. On an enterprise value/EBITDA basis, our valuation implies 9 times fiscal June 2015 estimates, and on a cash flow yield basis, our fair value estimate suggests approximately 3.7% cash flow yield for fiscal 2015, at the low end of a five-year historical range of 4%-6%. Fiscal 2015 metrics include \$55 million in one-time charges for store closings and restructuring. Our estimate for earnings per share in fiscal 2015 has not changed from \$1.69 GAAP, and our adjusted earnings per share estimate is up by one penny to \$1.82. For fiscal 2015 (year ended June), we project a revenue decline of 13.1% (unchanged), with mid-20s negative same-store sales growth implied in North America. Gross margins are now forecast to be below 68%, less than company guidance for around 70%. Although cost pressure worries have diminished, increased SG&A around the design changes should cause operating

margins to dip below 18%, in line with the company's expectations of high-teens operating margin but more negative than our prior assumptions. We model roughly 100 basis points of additional gross margin decline, year over year, in fiscal 2015, as we remain concerned that some inventory clearing may still have to occur in the outlets and that fresh product from the new designer may face some reluctant consumer acceptance. In fiscal 2015, we model capital spending of \$450 million. Over our 10-year explicit forecast period, we model operating margins first averaging 23.7% for the first five years going from under 18% in fiscal 2015 to over 27% in year five, and remaining between 26% and 27% after that. This is somewhat more conservative than the company's plans to return to 30% operating margins by fiscal 2019. Top-line growth to reach our cash flow-based valuation averages just over 4%, or just over 6% excluding the previously mentioned 13% decline forecast for fiscal 2015. Although we have increased our capital spending assumptions for fiscal 2015 through 2017, we model spending eventually returning to 4%-5% of sales.

## Risk

Remaining fashionable and extending the brand are constant risks at Coach, and as such we assign the firm a high uncertainty rating. If Coach extends the brand beyond what consumers understand it to be, the company could damage its core image or create confusion in consumers' minds. Coach has embarked on an ambitious plan to expand its product lines and become a full lifestyle brand, not unlike many older and more prestigious European luxury brands, but the strategy is not without risk. It is also now undertaking a pullback on promotions and a repositioning of the store base, in the same year it will launch new product lines from recently hired chief design officer Stuart Vevers. New designers hold promise, but there is always the risk that new lines and looks are not accepted by the public. In addition, there is fashion and execution risk at the product levels. Footwear does leverage some competitive advantages in leather sourcing but, in our opinion, is a different category from bags and accessories. Men's accessories have lower risk, in our opinion, and we agree that the men's leather goods market is underserved, but we cannot be sure that the extension will not dilute the women's business. The new fashion designs have met with very positive reviews in the fashion press, yet no amount of testing and publicity can assure success with consumers. While Coach has established a niche in the fashion world, and customers are very brand-loyal in the handbag and accessories category, it runs the risk that changes in tastes and preferences will eventually lead consumers to believe it is a brand for a past era. Coach also has been successful thus far extending the brand into new geographies, and a portion of our fair value estimate is based on that continued expansion. Today, sales growth prospects appear strong, but there is a risk that new entrants or other market forces could derail the international projects that today look promising for Coach.

## Management & Stewardship

Lew Frankfort was replaced by Victor Luis at the beginning of 2014. Luis, who was head of international operations, has been assembling a new team of designers and management, including a new creative director, Stuart Vevers. His experience includes terms as CEO of Baccarat, running North America, and with other LVMH brands earlier in his career. We believe his international experience will be important to develop the future growth of the firm. A majority of Coach's board is independent, and officers and directors own nearly 5% of the shares outstanding. Frankfort is currently chairman but will retire after the November annual meeting. Jide Zeitlin, currently the lead outside director, will be appointed the next chairman of the board. Thus the chairman and CEO roles will remain split, a structure we view favorably. We believe management does a good job of providing transparency around the business. Overall, corporate governance is sound and aligned with shareholders, in our opinion, and we rate Coach's stewardship of shareholder capital as exemplary given its long record of above-average returns and recent actions to return cash to shareholders. We note that in 2013, Frankfort bought Coach shares on the open market, despite having announced his diminishing role.

## Profile

Coach is a manufacturer, distributor, and retailer of handbags and accessories and is

expanding to broader product categories. Its products offer the quality of higher luxury brands but at more attractive price points. While 60% of sales come from more than 500 North American retail stores, Coach also sells its products through department stores, international shops, the Internet, its catalog, and Coach stores in Japan and China. Coach recently established a foothold in Europe, where it plans to reach \$100 million in sales in fiscal 2015.