Investors Alley
Blue Chip Gems

Keeping Things Domestic for the Summer

Fellow Investor,

It looks like the markets will close out what had been a flat month with a bang. The trigger of course was the U.K. decision to leave the European Union some four decades after becoming a core member. Although polls between the "leave" and "stay" camps showed a neck and neck race, investors still managed to get caught flat footed as the consensus in the market was that "cooler heads" would prevail and that the "remain" faction would win in a close vote.

In This Issue

Signet (SIG).. 3
Portfolio Update 6
Current Portfolio Standings 7
Closed Positions 8

Pundits were once again wrong on this call; 2016 has been a miserable year for consensus forecasts whether it has been around the trajectory of interest rates, price of crude oil, or the U.S. primary results. Both the so-called elite and economic pundits alike have not taken into account how much anger and angst has welled up in the electorates of a majority of developed nations after a decade of slow economic growth, tepid job gains, a rise in terrorist acts, major expansions of regulations, and massive intervention by the world's central banks. Looking back with hindsight, the U.K. deciding to leave the EU seems almost logical given those cross currents.

The vote has already claimed victims and had ramifications in global currency and equity markets. The pound cratered more than seven percent against the dollar in trading Friday and the sterling hit its lowest levels against the greenback in some three decades. The Euro also sold off, but only a little over two percent against our currency. Even though the markets have regained some of the losses from the surprise Brexit decision, both currencies failed to regain much ground against the dollar.

The renewed strength of the dollar will continue to put pressure on the earnings from the S&P 500 and might prolong the "profit recession" which has seen four straight quarters of year-over-year earnings declines in the S&P 500, the longest such stretch since the financial crisis.

The European bourses had their worst one-day performance since 2008 on Friday. However, to put it in perspective, stocks just gave back their gains of the previous ten days in anticipation of a "Stay" vote. Gold and other precious metals surged to close the week thanks to the increase uncertainty this event has introduced in the markets while oil and most other commodities fell sharply on concerns on the impact of global growth this decision might have.

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David Cameron, the prime minister of England, has announced he plans to resign in three months as the result of this outcome. Already, furious cries ring out from Scotland pushing for a referendum to vote on whether they stay in the European Union, given over 60% of that country voted to "stay" in this vote.

Financials are the biggest losers in this vote, especially those with large footprints in the city of London. Much of the regulations that govern the financial services industry and allow for cross-border transactions are at the EU level. These will now have to be renegotiated, a process that is likely to be long and arduous. In addition, the "flight to quality" is further pushing yields down and punishing net interest margins at banks which will hurt the returns on investment portfolios of insurers.

Ending on a brighter note, I think any rate hike from the Federal Reserve is kaput for 2017 and probably for a good portion of 2018, which should help growth prospects on the margin. It is going to be a very interesting month ahead as the markets work through the ramifications of this unexpected event.

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

Thank you and Happy Hunting.

Bret Jensen
Editor
Bret Jensen's Blue Chip Gems

A Diamond is Forever

In the Blue Chip Gems portfolio, we will continue to de-emphasize financials given that forecasts for when we will see the next interest rate hike continue to be pushed back; volatility has also spiked in any financial business thanks to unexpected "Brexit" outcome last week. Finding firms that are more driven by domestic demand seems a good play in the current environment. The United States may be mired in the weakest post-war recovery on record, but it still remains the best house in a very dilapidated neighborhood among developed nations at the moment.

In this month's edition of Blue Chip Gems, we add **Signet Jewelers Limited (NYSE: SIG**). You may not recognize the name of the retailing holding company, but you certainly recognize the brands it manages and owns in the retailing Jewelry space. The stock has been unfairly sold off of late, is now cheap, and is seeing solid revenue and earnings growth despite a challenging global backdrop. Insiders have also been buying shares in the stock after its recent decline, a nice vote of confidence.

Company Overview:

Signet Jewelers is the largest specialty jewelry retailer in the US, UK, and Canada. Signet operates approximately 3,600 stores primarily under the name brands of Kay Jewelers, Zales, Jared the Galleria of Jewelry, H. Samuel, Ernest Jones, Peoples, and Piercing Pagoda. The company's annual sales of approximately $6.5 billion are derived from the retailing of jewelry, watches, and associated services. The company has been around since 1950 and is located in Bermuda. With its purchase of Zales in 2014, Signet increased its market share leadership to approximately 17% of the global jewelry market. **Tiffany (NYSE:TIF)** is number two with just over five percent of the overall market in this fragmented industry.

The Advantages of Being Market Share Leader:

The jewelry business is a very difficult space. Over 700 jewelry stores went out of business last year or about 2.5% of the overall total. Being big provides large synergies; acquiring merchandise, running national and regional marketing campaigns, buying insurance, and building/maintaining your own credit operations all become much cheaper when you achieve scale. This is one of the keys to Signet's success as it powers additional sales and earnings. Given the dynamics and economics of the retail jewelry space as well as Signet's relatively small market share despite being the 800 lb. gorilla in the industry, the company should continue to gain market share in this fragmented part of the retailing world. Therefore, the company should continue to grow by both same store sales increasing and by opportunistically adding to its sales footprint via acquisition.

Growth:

Over the past ten years, the company has grown revenues at an average 7.6% annually thanks to organic growth and acquisitions. This is more than three times the industry average over that time span. That growth rate is also more than twice the average rate of the entire retail market over this period. It is important to emphasize that although the company has benefited from consolidating the industry via acquisitions, its same-store sales were more than the industry average as well over the past decade. Signet has managed to do well with revenue growth even during the aftermath of the financial crisis and within the weakest post-war recovery on record.

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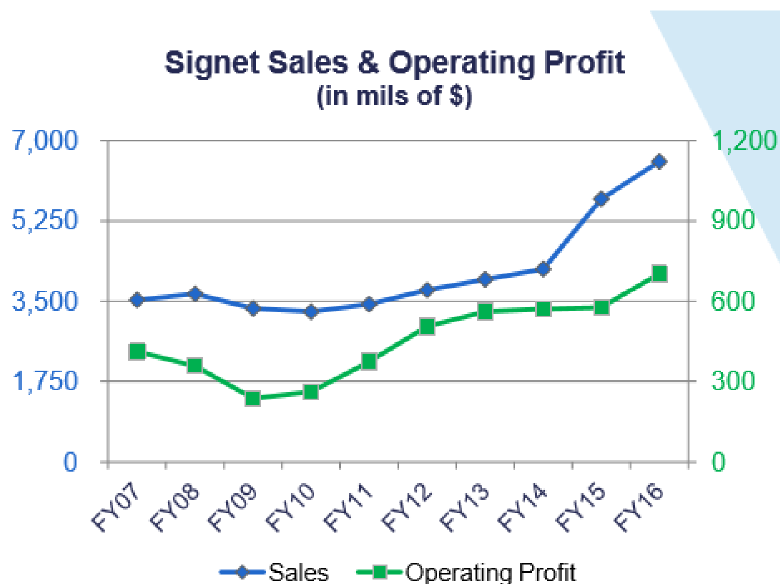

Recent Results:

In the last completed quarter, the company posted earnings of $3.63 a share, slightly above the consensus while revenues came in just below projections. The company saw same-store sales grow a tad under five percent and e-commerce sales moved up over 11% on a year-over-year basis to north of $165 million. Both operating and gross margins advanced approximately 160 basis points as the company continues to benefit from its Zales purchase. Cost synergies from that transaction are already ahead of schedule. The company guided for $8.25 to $8.55 a share of earnings in this fiscal year.

"Diamond Swapping" and Other Concerns:

There have been a couple of concerns that have held the stock back so far in 2016. One is recent and that is the Brexit vote as Signet has a significant presence in the U.K. with its stores. However, sales from the region are approximately one eighth its overall revenues and that should be more than manageable. Another four to five percent of sales come from Canada. Signet gets the vast majority of its revenues (> 80%) from the United States so this worry seems overblown. We have also seen a slight erosion across credit quality in recent months across many financing categories including auto loans and credit cards at a variety of banks. However, outside a significant recession, this should be more than manageable.

The bigger issue and threat to its brand is that there have been some incidences of "diamond swapping." Some of the company's customers have accused it of losing or replacing their diamonds with those of lesser quality. The CEO was on CNBC recently calling the impact from this story "negligible," and isolated; the company is seeing consumer complaints in just .2% of all repair orders. A recent Cowen & Co. survey also shows the company's mainstay brands (Zales, Kays, Jareds) continue to top brands like Macy's, Nordstroms, and Blue Nile as far as positive views from consumers around jewelry purchases. Signet's brands only trailed that of Tiffany which obviously has the much higher price point and luxury classification. The company also reaffirmed previously forward guidance, something I doubt it would do if this was a significant issue. It certainly does not warrant the recent decline in the stock price in my opinion.

Balance Sheet and Cash Flow Plans:

The company has a solid balance sheet and maintains an investment rating. Signet also throws off nice free cash flow. The firm's stated goal for this free cash flow is to primarily reward shareholders by returning 70% to 80% of free cash flow over time via dividends and share buybacks, mainly the latter. The stock pays a one and a quarter percent dividend yield and the dividend payout has gone up 160% since the company emerged from the financial crisis.

Signet focuses more on returning cash flow to shareholders via stock buybacks. It recently raised its stock buyback authorization to just over $750 million which it plans to exercise completely over the next two to three years. The company took advantage of the recent weakness of its stock to buy back $121 million worth of shares in the last completed quarter. With its current market capitalization, the remaining buyback program will retire over 10% of the outstanding float and raise earnings per share by a similar amount at current market prices. This obviously will be a solid tailwind for earnings growth over the next couple of years.

Outlook:

I think the large recent dip in the stock price of Signet is a great entry point to build a stake in this well-run retailer that is the biggest player by far in its space. I am not the only one who thinks this either, over a half-dozen insiders have bought over $1.2 million in new shares so far in June. The stock is cheap given its growth prospects at around 10 times this year's projected earnings. The name has traditionally sold for around 15 times earnings.

Signet will continue to see same-store growth as well as benefit from consolidation in the industry adding to its market share lead. Revenues should continue to increase in the mid-single digits on an annual basis. Thanks to operation efficiencies as well as the large buyback authorization program, earnings should continue to rise in the mid-teens. 13 analysts currently cover the stock. Their price targets range from $115 to $155 a share, all substantially above Signet's current price in the low $80s.

Recommendation: Buy SIG up to $90

Position: Long SIG

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Portfolio Update

Brexit certainly upset the apple cart during the last part of June with the major indices plunging some six percent Friday and Monday, before a solid bounce back rally on Tuesday and Wednesday. I would look for equities to continue to have "rips" and "dips" as investors and governments work through what exactly the implications and ramifications are for a divorce between the U.K. and the European Union after four decades of an up and down marriage.

One of the biggest impacts to large caps from this event is a noticeable strengthening of the dollar triggered by a flight to safety after the unexpected outcome of the vote. A strong dollar has already been a key factor behind four straight quarters of declining year-over-year profits within the S&P 500. Look for the dismal stretch to go to five quarters when second quarter earnings reports start to trickle in two weeks out. I wouldn't be surprised if many companies use this event as an excuse for poor performance in the quarter.

One of the biggest losers in the aftermath of this event is the financial sector. Not only did the flight to quality dramatically lower yields but it put any interest rate hike in the near future and probably for the rest of 2016 from the Federal Reserve off the table. This will significantly impact net interest margins for banks, a major profit contributor.

In addition, major banks that have footprints in London and an entry point into the European Union will have to navigate myriad possible regulatory changes while the U.K. untangles itself from the European Union. M&A seems to have declined somewhat and IPOs are increasingly rare in this environment as well.

We will be disgorging **Blackstone (NYSE: BX)** from the portfolio due to the increasing negatives on the financial sector. Signet has better near-term prospects and will take its place in the portfolio this month.

As of this issue, Blackstone will now be found in the 'Closed Positions' section of the portfolio.

Elsewhere in the portfolio, our healthcare and biotech positions held up somewhat better than the financials over the past month but this space of the market is still being pressured. Biotech continues to be in its deepest and longest bear market since 2008. Collectively, the large caps in this space sell at their lowest collective valuation since the Greek debt crisis of 2011 and represent good value in a challenged market at the moment. The healthcare sector is also one of the few in the market that is seeing both revenue and earnings growth in this dismal global backdrop at the moment.

Both should do much better after all the election driven rhetoric around drug price gouging and price controls ends up producing little if anything in the way of new legislation.

Macy's (NYSE: M) was one of the few positions in the portfolio that bucked the downward trend of the S&P 500 this month as it battled back some from oversold levels. Its long time president is moving on and will take over as Chairman of this retailer.

Current Portfolio

Company	Entry Date	Entry Price	Recent Price	Yield	Returns	S&P 500 Comp.
Signet Jewelers Ltd. (SIG)	6/29/2016	$82.00	$82.00	1.3%	N/A	N/A
Pfizer (PFE)	05/27/16	$34.61	$35.01	3.5%	1.2%	-1.3%
Allergan (AGN)	04/18/16	$219.91	$230.55	-	2.2%	-1.1%
Teva Pharmaceuticals (TEVA)	03/28/16	$53.85	$50.26	2.7%	-6.7%	1.7%
Synchrony Financial (SYF)	02/25/16	$27.78	$24.83	-	-10.6%	6.1%
Wells Fargo (WFC)	01/25/16	$47.66	$46.97	3.3%	-1.4%	10.3%
Alphabet (GOOGL)	12/28/15	$782.24	$695.19	-	-11.1%	0.7%
Macy's (M)	11/24/15	$39.63	$33.32	4.7%	-15.9%	-0.9%
Merck (MRK)	10/27/15	$53.47	$57.05	3.3%	6.7%	0.2%
Amgen (AMGN)	08/28/15	$155.89	$150.10	2.7%	-3.7%	4.1%
Celgene Corp. (CELG)	06/26/15	$117.92	$98.81	-	-16.2%	-1.5%
Qualcomm (QCOM)	04/15/15	$68.46	$53.55	4.1%	-21.8%	-1.7%
Capital One (COF)	04/15/15	$82.82	$61.92	2.6%	-25.2%	-1.7%
Foot Locker (FL)	03/18/15	$61.17	$55.08	2.1%	-10.0%	-1.4%
AbbVie (ABBV)	02/13/15	$58.05	$61.81	3.8%	6.5%	-1.3%
Gilead Science Inc. (GILD)	01/16/15	$100.71	$82.27	2.3%	-18.3%	2.5%
Apple Inc. (AAPL)	01/16/15	$105.99	$94.40	2.4%	-10.9%	2.5%
Las Vegas Sands Corp. (LVS)	01/16/15	$54.89	$43.63	6.7%	-20.5%	2.5%

Recent Price is updated from stock closings on 06/29/16

Closed Positions

Company	Entry Date	Entry Price	Close Price	Returns	Close Date
Blackstone Group (BX)	05/18/15	$43.64	$24.75	-43.3%	06/29/16
JP Morgan (JPM)	01/16/15	$55.93	$65.43	17.0%	05/27/16
Valero Energy (VLO)	02/13/15	$58.60	$60.71	3.6%	04/18/16
Express Scripts (ESRX)	03/18/15	$83.29	$67.67	-18.8%	03/28/16
Allergan (AGN)	09/29/15	$254.87	$296.34	16.3%	02/25/16
Bank of America (BAC)	07/28/15	$17.88	$12.96	-27.5%	01/15/16
Micron Technologies (MU)	1/16/15	$28.99	$14.19	-51.1%	12/28/15

Notes:

Entry price is determined by the last "Close" price at the closing of the market on the day before publication. Recent price is determined by the last "Close" price at the closing of the market on the day before publication; most recent update: 06/29/16. Returns is share price appreciation or depreciation between entry price and recent price. S&P Comp. represents the returns on the S&P 500 Index from the point of entry of a stock listed above through the recent price and is meant to provide a comparison to the overall small cap stock market as comprises that index.

This is not real-time data and should not be interpreted as such.

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