March 2017

By Tony Daltorio, Editor of Investors Alley's Premium Digest April 1, 2017

The momentum of the so-called Trump trade has certainly slowed. The return on the S&P 500 index over the past month is -1.5%.

... The Nasdaq Composite index (with Tech being the best performing sector) is down 0.10% over the past month, while the Russell 2000 index of smallcap stocks is down nearly 3%. (The Dow's first eight-day losing streak since 2011 and only the third such streak since 1990 ended with Tuesday's rally.)

This really isn't surprising considering how far and how fast the stock market climbed since Trump was elected President.

With all the fighting among the 'swamp animals' in Washington D.C., the markets may be stuck in a quagmire for a while longer.

Market History

Investors should be used to this state of affairs in the U.S. stock market.

Just think back to recent history…

Both the S&P 500 index and the Dow Industrial Average were little changed from late 2014 to the middle of 2016. No new highs were hit for over a year.

During that time, markets struggled because U.S. companies were in the midst of an earnings recession for almost the same length of time. Now earnings are improving, but politics may become a problem.

Stuck-in-the-mud market action is nothing new…

According to Bespoke Investment Group, the period I just described was the 21st time since 1930 that the market had gone a year without making a new high.

For newer investors, it's one of the dirty little secrets financial advisors don't like to talk about and that you will never hear about on CNBC (where the "Trump Rally" had become the "Trump Slump").

The stock market, on occasion, will go through periods – sometimes for years – without making any headway.

That history is why, when I was an advisor, I went against consensus thinking and told my clients to steer clear of S&P 500 index funds.

Especially if you're approaching retirement. Can anyone near retirement afford to have their money just tread water for possibly years and earn nothing?

Don't be fooled by index funds' recent history. They look good thanks to the flood of central bank liquidity since the financial crisis, lifting large-cap stocks, especially. But that 'easy money era' globally seems to be drawing to a close.

What to Do

So what can investors do? Where to put money safely, but still maintain some growth? ...

I think one of the best ways to play stocks currently is to stick with the dividend payers. And I continue to like a global approach. In effect, spreading my bets.

I like this global approach with the massive outperformance of the U.S. market versus Europe and emerging markets over the past five years.

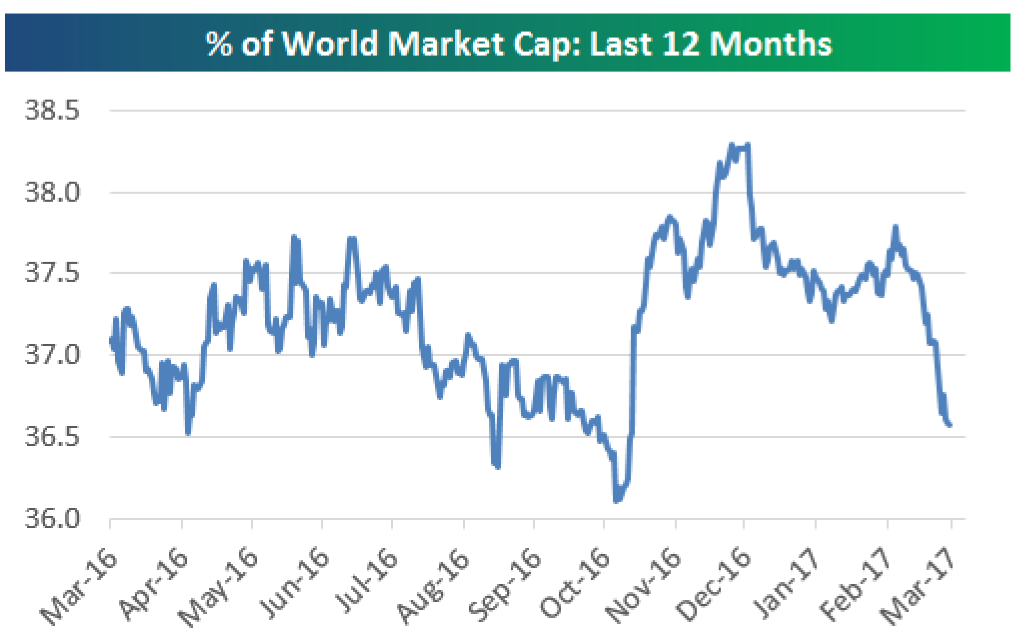
My years in the markets have taught me that mean reversion in financial markets is very real. So, I expect that Europe and emerging markets have a lot catching up to do. Let's hope the mean reversion doesn't go the other way with the U.S. market falling.

Our thoughts - While we have previously shared some of the academic evidence that Dividends should not be a Factor in stock selection, we have repeatedly stressed the importance of International diversification.

US Quickly Losing Share of World Market Cap

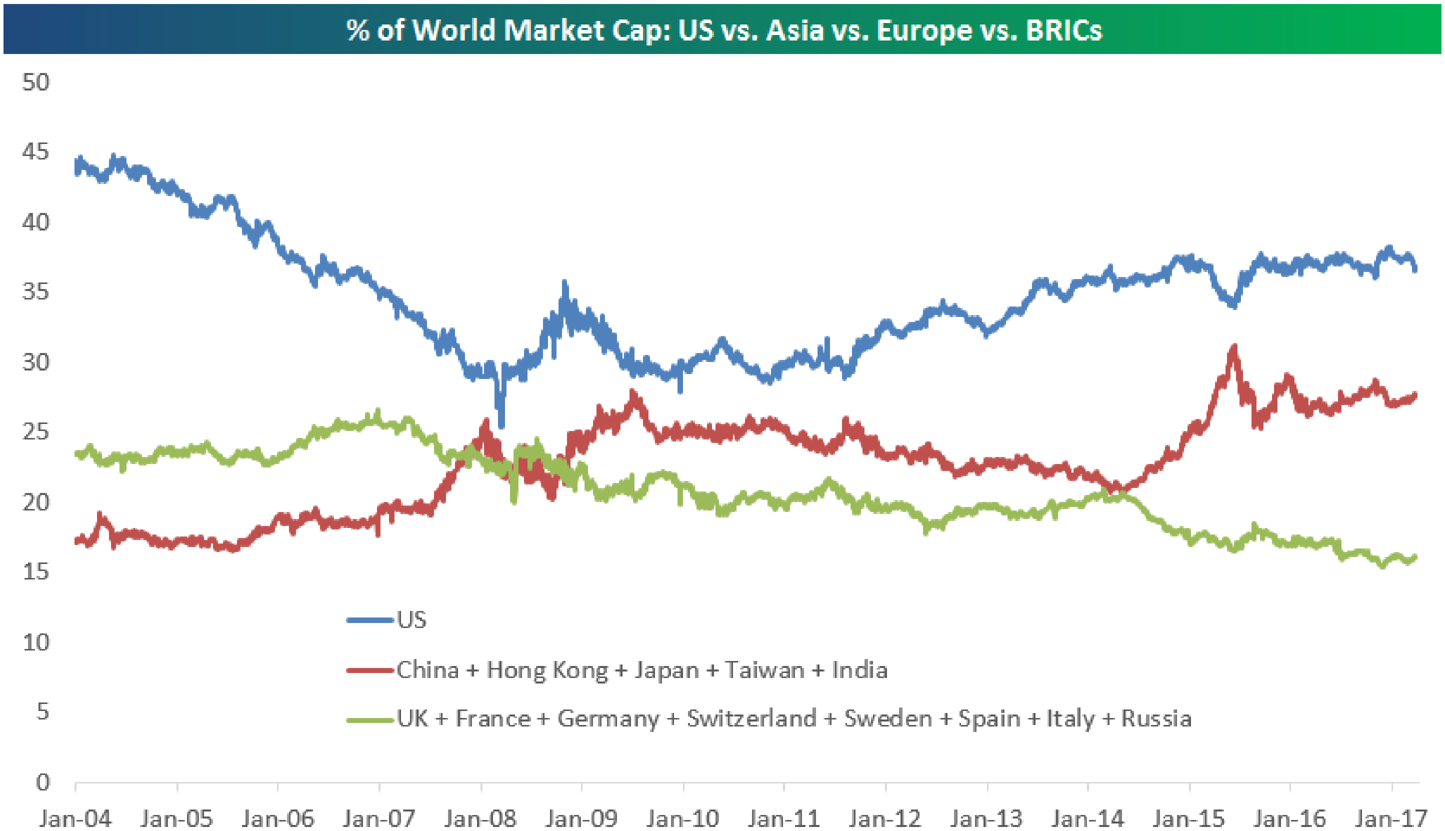
Mar 27, 2017

Below is a one-year chart showing the percentage of total world equity market capitalization that the US stock market makes up (from *Bloomberg*'s world market cap indices). Heading into the 2016 Presidential Election, the US was losing market share to the rest of the world. But following President Trump's victory, this reading shot up from just over 36% to nearly 38.5%. That's a huge move.

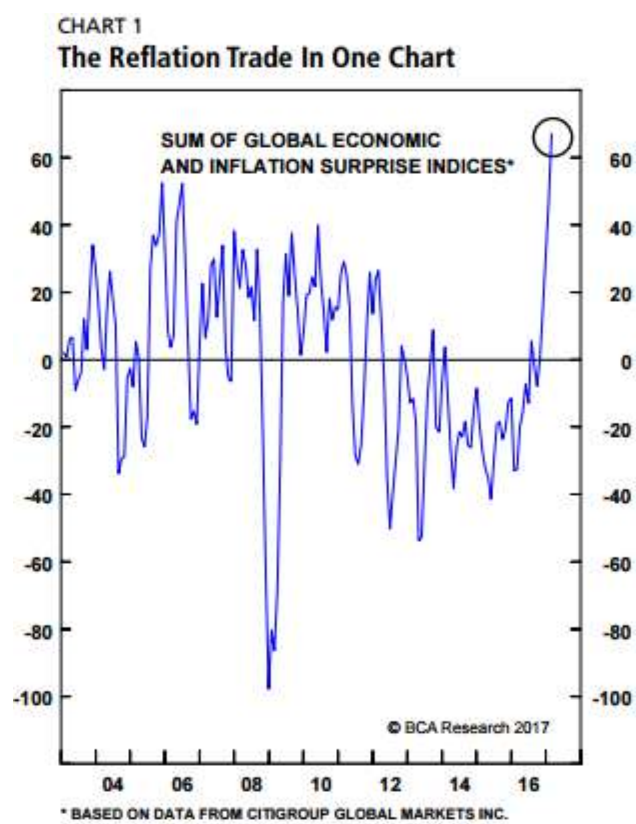


Since peaking at the end of 2016, however, we've seen a steady drift lower down to just above 36.5%. At this point the US has only gained a very small % of share in world market cap since Trump's victory night.

Below is chart that highlights shifts in world market cap since 2004 for the US, Europe, and Asia. As you can see, from 2004 through mid-2007, Europe had the second highest share of world market cap behind the US. But once the Financial Crisis hit, Asia eclipsed Europe, and at one point in mid-2009, Asia was just a couple percentage points away from the US. As the current bull market has progressed, the US has re-gained a sizable lead in first place, while Asia now sits solidly in second place. Europe, however, has been trending lower and lower…and lower.



Our thoughts continued - So with the Republicans failure to "repeal and replace" Obamacare casting doubt on their ability to reduce corporate taxes, why has Mr. Market's response been muted, so far. Perhaps, just perhaps, the Financial Markets aren't as fixated on Trump as the talking heads on CNBC and elsewhere have proclaimed. From Friday's Global Investment Strategy Outlook:



"If there is one chart that best encapsulates the reflation theme, **Chart 1** is it. It shows the sum of the Citibank global economic and inflation surprise indices. The combined series currently stands at the highest level in the 14-year history of the survey. Consistent with the surprise indices, Goldman's global Current Activity Indicator (CAI) has risen to the strongest level in three years. The 3-month average for developed markets stands at a 6-year high (**Chart 2**). ...

Looking out, global growth should stay reasonably firm over the next 12 months. Our global Leading Economic Indicator remains in a solid uptrend. ...

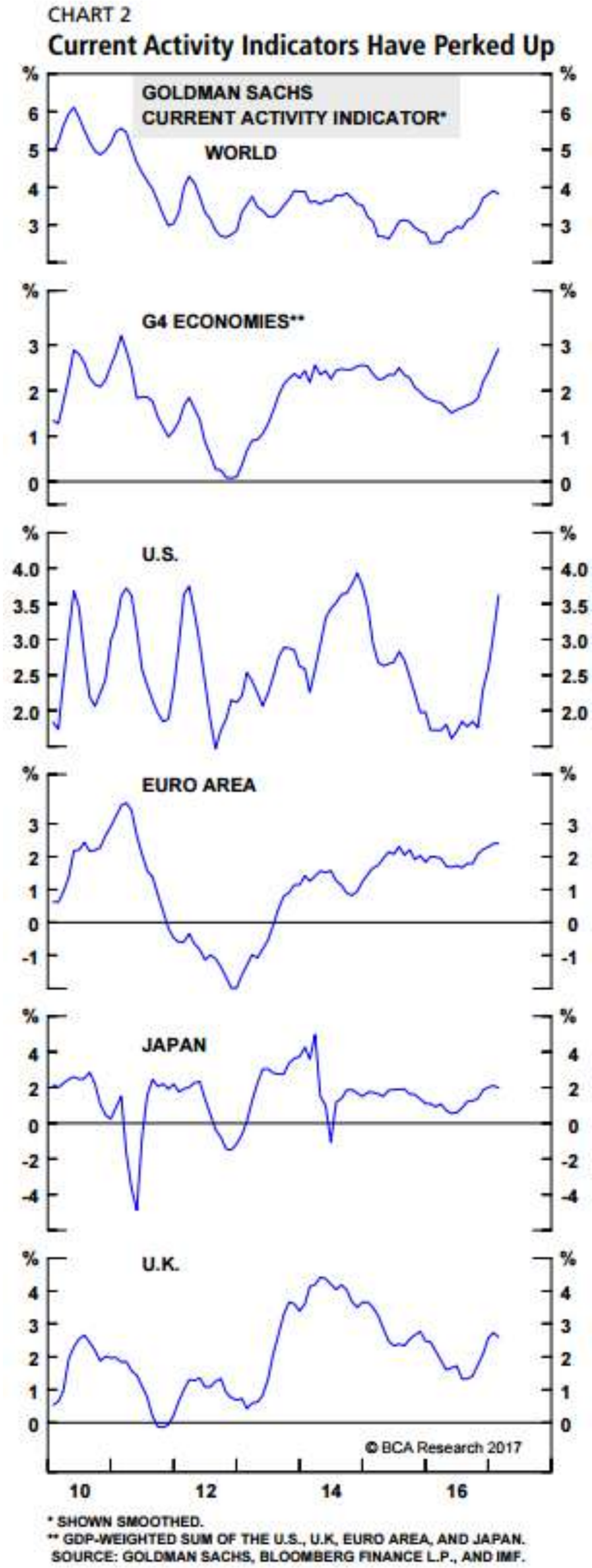
The failure to replace the Affordable Care Act has cast doubt in the eyes of many observers about the ability of Congress to pass other parts of Trump's agenda. As a consequence, the "Trump Trade" has gone into reverse over the past few weeks, pushing down the dollar and Treasury yields in the process. We agree that the "Trump Trade" will eventually fizzle out. However, this is likely to be more of a story for 2018 than this year. ...

The failure to pass an Obamacare replacement serves as a reminder that comprehensive tax reform will be more difficult to achieve than many had hoped. However, even if Republicans are unable to overhaul the tax code, this will not prevent them from simply cutting corporate and personal taxes. (We are less sanguine.) Worries that tax cuts will lead to larger budget deficits will be brushed aside on the grounds that they will "pay for themselves" through faster growth (dynamic scoring!). Throw some infrastructure spending into the mix, and it will not take much for the "Trump Trade" to return with a vengeance. ...

As such, the risk to the economy beyond the next 12 months is that markets push up the dollar and long-term interest rates in anticipation of continued strong growth and lavish fiscal stimulus only to get neither. ...

Risk assets have enjoyed a strong rally since late last year, and a modest correction is long overdue. Still, as long as the global economy continues to grow at a robust pace, the cyclical outlook for risk assets will remain bullish. As such, investors with a 12-month horizon should stay overweight global equities and high-yield credit at the expense of government bonds and cash. ...

Stronger global growth is powering an acceleration in corporate earnings. Global EPS is expected to expand by 12% over the next 12 months. Analysts are usually too bullish when it comes to making earnings forecasts. This time around they may be too bearish. ...



We prefer euro area and Japanese stocks relative to U.S. equities over a 12-month horizon. We would only buy Japanese stocks on a currency-hedged basis, as the prospect of a weaker yen is the main reason for being overweight Japan. In contrast, we would still buy euro area equities on a U.S. dollar basis, even though our central forecast is for the euro to weaken against the dollar over the next 12 months. ...

Emerging market equities tend to perform well when global growth is strong. Thus, it would not be surprising if EM equities continue to march higher over the next 12 months. However, the structural problems plaguing emerging markets that we discussed earlier in this report will continue to cast a pall over the sector. ..."

Finally - Another convert to taking a Quantitative, Factor-driven approach to stock selection?

BlackRock Sends in the Clones

By John Rekenthaler | 03-31-17

You've Been Automated!
The news that BlackRock sidelined seven of its equity-fund managers didn't make many front pages (It did in Wednesday's WSJ with the headline **BlackRock Shake-Up Favors Computers Over Humans**.), but within the small world of professional money management it was a big story indeed. The world's largest investment manager--Vanguard is the leading mutual fund company both in the United States and globally, but BlackRock runs more assets in all forms--swapped living, breathing people for stock-picking models. Fear the rise of the machines.

Said BlackRock CEO Larry Fink, "The democratization of information has made it much harder for active management. We have to change the ecosystem--that means relying more on big data, artificial intelligence, factors, and models within quant and traditional investment strategies."

For those who don't speak investment jargon, Fink meant that fund managers no longer benefit from trade secrets. Back in the day, corporate executives freely chatted with investment professionals, particularly those who held their company's shares and/or controlled a great deal of money. They would discuss their company's latest developments, as well that those of their industry. That information gave fund managers a significant edge on the rest of us.

That benefit is mostly gone. The SEC has tightened its interpretation of prohibited communications, so that executives have become more circumspect. They can sometimes be tempted into disclosures, which is one reason fund managers still seek personal meetings, but the opportunities have diminished. ...

Also, competition has increased. Although Fink's decision reduces the mutual fund manager count by seven, there are nevertheless more actively managed U.S. stocks (funds) today than there were 20 years ago. And as fund companies these days are more likely to name an investment team to run a fund rather than a single "star" manager, the number of official portfolio managers has grown at an even higher rate. These days, there are more rivals to beat.

The Battle Continues
Of course, switching from humans to algorithms doesn't eliminate the contest; as before, BlackRock must outdo its opponents to earn its management fees. The company hopes that by being earlier than most to embrace artificial intelligence, and being larger than all, that it will enjoy a competitive advantage. That seems plausible. But even if BlackRock's change does improve its funds' returns, there remains the question of sustainability. Success breeds imitators, and imitators erode success. Winning investment management demands constant reinvention.

To summarize the first and most important lesson of BlackRock's announcement: The demise of the traditional portfolio manager continues. Because of mergers and liquidations, there are fewer actively managed U.S. stock funds today than there were last year; and now, per BlackRock's example, those that continue to exist might concede to clones. That's bad news for stock-market junkies who wish to enter the investment business. Eventually, if enough funds convert, the level of competition will decline such that active managers will have an opportunity. But we are currently far from that point.

Doing It All

Another takeaway: It is hard to win across all asset classes. BlackRock is the world's largest active fixed-income manager and the biggest exchange-traded fund provider. Each of those are huge endeavors. It took three decades, and intense focus from senior management, to build that bond-market expertise. Winning the ETF asset battle was another struggle. Seeking excellence with actively managed stock funds might have been one ambition too far.

Indeed, when asked if a major fixed-income manager had ever accomplished that feat, Morningstar's research team demurred. Perhaps Franklin Templeton. But the catch to that example is suggested by its name. Franklin did not create its stock-fund business--although it tried for many years--but instead bought that capability from a company that was already so established that it came aboard with equal billing. Franklin Templeton absorbed its purchase well, but a purchase it was--not a creation.

(The same cannot be said in reverse. Whereas Fidelity was once thoroughly average at running investment-grade bonds, it now is among the best. That change came completely from within. Unfortunately for Fidelity, as its bond funds improved, its U.S. stock funds regressed, thereby preserving this column's thesis about the difficulty of succeeding with all asset classes.)

Stocks, Not Bonds?

The third point puzzles me. BlackRock's action suggests that there is more opportunity for traditional active managers with investment-grade bonds than with U.S. stocks. BlackRock, after all, did not remove its fixed-income managers. They, apparently, are still able to compete with index strategies. How could this be? If the U.S. stock market is so thoroughly researched that active management is much stymied, then what about investment-grade bonds? They are no less scrutinized; and, at the top of the credit ladder, they're simpler to analyze, because they mostly respond only to changes in interest rates.

As Morningstar's Jeff Ptak writes, "Supposing that one concedes that point (that the old method of security selection has become obsolete), why are bonds--where BlackRock has enjoyed greater success--any different? Sure, there are some clear differences in how those markets are structured, how indexes are built, and so forth. But would BlackRock argue that someone should invest more in active fixed-income funds than in active equity funds because the former is the easier task?"

My guess is that BlackRock would deflect the question, by stating that it is happy with its fixed-income management but felt that its equity approach needed to be tweaked. My guess is also that if Jeff Gundlach of DoubleLine (who manages TOTL, the ETF we use for excess cash) were asked a similar query, he would give a similar response. Portfolio managers tend to talk about what they believe that they do well, rather than theorize about market structures. But it's true that there is more faith these days in active fixed-income management (all of the Income Funds we use for clients are actively managed) than in active U.S. stock-fund management. It is hard to explain why. (The reason is historical performance.)

Positions

HRZN - This technology focused BDC had been on our buy list since heavy Insider Buying in March of `16.

HORIZON TECHNOLOGY FINANCE (HRZN: $10.45)
March 8, 2017
Rating: Buy Price Target: $13.50

Focused on Covering Dividends and Creating Value in 2017

Summary

Buy-rated Horizon Technology Finance Corp. (HRZN) reported full year NII of $1.48, covering distributions of $1.34 for the year. In November, 2016, the BOD chose to cut the dividend by 13% to $1.20 (paid in $0.10 monthly installments) because it expects the investment portfolio could continue to shrink. This may prove conservative, but we believe it was a prudent action. NAV contracted from $15.85 to $12.09 by year end, as several portfolio companies failed to meet milestones and/or failed to refinance their debt. In 2017, we believe HRZN will rebuild its portfolio and drive value creation as troubled credits are resolved. Our $13.50 target is supported by the potential for portfolio growth in 2017, as well as by the hidden value in HRZN's extensive warrant portfolio. Maintain Buy.

Key Points

Plans and visions. HRZN experienced positive portfolio events in 2016, including liquidity events, end of term payments, and warrant monetizations. However, the company also had a high level of nonperforming credits, which it took steps to resolve (see Figure 1). The portfolio contracted, as borrowers and sponsors seemed to have unrealistic pricing expectations. We are fairly confident that the portfolio will grow in 2017, troubled credits will continue to subside, and that NII will cover the distribution without incentive fee deferrals.

Incentive fee deferral mechanism. In 2014, HRZN amended its management contract to allow for a deferral of incentive fees if cumulative incentive fees exceeded total earnings (inclusive of gains or losses). This threshold was tripped in 3Q16 and we believe incentives will be deferred through 1Q17. In 2H17, we think portions of the deferred incentives could begin to be paid to the manager, but that it could take until the end of 2018 before the deferred incentives are recaptured.

Resolution of troubled credits. Three troubled credits achieved resolution in 4Q16 or early 2017: New Haven Pharma sold certain assets to Espera Pharma, and Espera entered into a royalty agreement with New Haven's creditors. HRZN marked this asset to ~51% of par, but could make a full recovery over time. ScoreBig was purchased by TicketNetwork, and offered a similar royalty agreement to creditors; that asset was marked to ~45% of par. Less favorably, Xtera's bankruptcy auction failed to recover any value for debtholders.

Estimates. The main revenue drivers are onboarding yields and volumes, paydowns and exit of investments, and end of term payments. HRZN has average ETPs of 4.8% of par on 91% of its debt investments, and we conservatively project 3% ETPs on quarterly paydowns. We assume investments of $30mm per quarter at 13% effective yields and paydowns of $15mm at 12.7% effective yields. Along with other assumptions detailed in the tables below, we are fine tuning our 2017E to $1.24.

Valuation. Our $13.50 target assumes that the accruing debt portfolio will be worth $12/sh as the portfolio expands in the next 12 months, and that the warrant portfolio will support another $1.50/sh of value, or 1.7x its current fair market value of $10mm. HRZN has seen NAV erosion, but we believe management has addressed troubled investments to maximize recoveries and has augmented its human capital resources to both grow the portfolio and restore value creation in 2017.

Merrill Ross   Wunderlich Securities

PE - Energy was the worst performing sector in the 1st Quarter, providing an opportunity to add 1% positions in this Permian Basin pure play E&P to accounts focused on Capital Appreciation.

Insider Buying:

Insider	Transaction	Type	Value	Date	Shares
ALAMEDDINE A R Director	Purchase at $30.94 per share.	Direct	108,290	Feb 28, 2017	3,500
WINDLINGER JERRY Director	Purchase at $30.35 per share.	Direct	91,050	Feb 27, 2017	3,000
GALLAGHER MATTHEW Officer	Purchase at $30.19 - $30.44 per share.	Direct	1,000,000	Feb 27, 2017	32,985

PARSLEY ENERGY (PE: $29.49)
February 27, 2017
Rating: Buy Price Target: $41.00

In Digestion Mode After Multiple Acquisitions

Summary

Parsley Energy (PE) delivered a strong quarter. The company started the year with two back-to-back acquisitions and grew its footprint and inventory significantly. Parsley has been very acquisitive since going public and the company is now in digestive mode; having ramped up to 10 rigs, the focus now is on execution. Midland Basin will continue to be its bread and butter; in addition to development projects, the company is testing Wolfcamp B both in the Upper and Lower intervals in additional to seeing promising results from the Wolfcamp C. We believe 2017 is going to be an interesting year for Parsley and we expect its inventory count to expand substantially. We reiterate our Buy rating on this high growth and returns-driven Permian pure play.

Key Points

Fourth quarter was in line. PE turned in a clean quarter with adjusted EPS of $0.06, CFPS of $0.45, and EBITDA of $117 million, in line with consensus. Realized oil and NGL prices were stronger than expected and all-in costs were 12% lighter than expected at $25.66/boe. The company will spend ~$1 billion with a gross completion count of 130-150 wells. PE is running 10 rigs, will add 4 more by year-end, and plans to grow production by ~70% this year.

Whirlwind acquisitions. Parsley did the $2.8 billion Double Eagle acquisition (added 71,000 net acres) this February right after the $607 million bolt-on deal this January (added 23,000 net acres). PE now holds 179,000 net acres in Midland Basin, 48,000 net acres in Delaware Basin, and 6,900 net royalty acres, with an inventory of 4,300 net locations in priority target intervals.

Midland Basin: strong tests from multiple intervals. PE released 30-day test data from two wells targeting the Lower Wolfcamp B and Upper Wolfcamp B in Upton County; the wells tested at 1,932 boepd and 2,194 boepd, respectively. PE also tested the Wolfcamp A and Lower Wolfcamp B from a single pad: combined, the two wells delivered 30-day IP of 3,386 Boepd. PE’s first Wolfcamp C well in Reagan county tested at a 24-hour IP rate of 2,414 boepd. PE plans to complete 95-105 wells in the Midland Basin in 2017.

Delaware Basin: first two wells in Reeves County delivered strong results. PE tested its first two wells in Reeves County: the Lincoln 4-1-4307H posted 30-day IP rate of 1,929 boepd (6,900’ lateral) and the Kauffman

State C4-6-4307H, delivered a peak 24-hr IP of 2,666 boepd (6,400' lateral). PE plans to complete 35-45 wells in the Delaware Basin, and drill a few Second and Third Bone Spring Shale wells later in 2017.

NAV and price target unchanged at $41. Our NAV estimate of $41 can be broken down into these component pieces: proved reserves of $9 per share, probable reserves of $35 per share possible resource of $2 per share. Netting out debt of $4 per share at year-end 2018, our NAV estimate is $41. Our NAV and 12-month price target of $41 is roughly 11.0 x our 2018 cash flow forecast of $3.71 per share.

Irene O. Haas Wunderlich Securities

STOR - A 2% position in this Triple Net equity REIT for a client that didn't already hold VER.

Insider Buying:

Insider	Transaction	Type	Value	Date	Shares
HIPP WILLIAM FRANKLIN Director	Purchase at $22.99 per share.	Direct	91,960	Mar 14, 2017	4,000
LONG CATHERINE F. Officer	Purchase at $22.52 per share.	Direct	124,986	Mar 12, 2017	5,550
SEADLER EINAR Director	Purchase at $22.46 per share.	Direct	99,722	Mar 12, 2017	4,440
VOLK CHRISTOPHER H Officer	Purchase at $22.75 per share.	Direct	252,525	Mar 9, 2017	11,100
BURBACH CHRISTOPHER K. Officer	Purchase at $22.65 per share.	Direct	124,574	Mar 9, 2017	5,500

STORE CAPITAL (STOR: $24.70)
February 24, 2017
Rating: Buy Price Target: $27.50

Maintaining 2017, Establishing 2018 As STOR Continues to Execute

Summary

We are maintaining our 2017 earnings estimates for Buy-rated STORE Capital Corporation (STOR) and establishing 2018 FFO & AFFO of $1.81 and $1.88, respectively. STOR is unique among its peers given its business model of more directly sourcing sale-leaseback opportunities with a retail tenant base that is more heavily comprised of middle-market, unrated tenants that are more dependent on bank financing and in which acquired real estate is a direct profit center for the tenant (as opposed to a cost center). Our $27.50 target represents 106% of our $26.07 NAV estimate (6.65% portfolio cap rate) vs. peers trading at 116% of NAV and represents a ~1.5x 2017E AFFO multiple discount to peers trading at 17x.

Key Points

4Q16 highlights. STOR reported 4Q16 AFFO of $0.43, $0.01 ahead of our estimate and $0.02 ahead of the consensus on a modest revenue beat ($102mm vs. $101mm est.) as STOR closed ~$45mm more of acquisitions than forecast (net), as well as lower G&A than expected and positive straight lining of rents. SS NOI improved from 1.7% to 1.8% as did as occupancy sequentially (+30bp to 99.5%). Acquisition cap rates on a gross $325mm averaged 7.9% (vs. 7.75% est.) and 2017 AFFO guidance was reiterated at $1.74-$1.76.

Gander Mountain – discussed at length, but not expected to be an issue. Gander Mountain represented 2.2% of annualized base rent going into 2017, and though lingering concerns remain about a potential bankruptcy filing imminently, management noted that it was confident in the knowledge of the strength of the store-level performance (a critical differentiator for STOR) at those sites and that any event had been contemplated as a component of guidance.

Key modeling assumptions unchanged. We continue to look for a net $900mm of acquisitions per guidance (vs. an average $1.2B STOR has closed ~$1.2B per year the last two years) at a 7.75% cap rate (vs. 7.9% YTD) and effectively flattish leverage levels (with net debt/EBITDA forecast in a tight band around 6x throughout the year) as free cash flow, $500mm of equity, and debt fund balance sheet growth. SS NOI should trend along at 1.8% given rent escalators while G&A should remain at ~70bp of portfolio assets.

Maintaining 2017 estimates, establishing 2018. We are maintaining our 2017 earnings estimates on STOR, with our 2017 FFO remaining at $1.69 and 2017 AFFO at $1.76. We are also establishing a 2018 FFO/AFFO of $1.81/$1.88, using similar modeling assumptions as in 2017. We project a 2017 AFFO payout ratio of 64% (down from 4Q16's 68%), declining to 61% in 2018.

Maintain Buy, $27.50 target. Our $27.50 target represents 106% of our $26.07 NAV estimate (6.65% portfolio cap rate) vs. peers trading at 116% of NAV and represents a ~1.5x 2017E AFFO multiple discount to peers trading at 17x. We believe STOR's superior capacity for growth and its proprietary source of deal flow should lead it to achieve acquisition cap rates elevated relative to peers for the foreseeable future, leading to persistent earnings growth given an estimated current cost of capital of 7.1%.

Craig Kucera   Wunderlich Securities