BARRON'S COVER

# Barron’s Roundtable: 22 Smart Investment Ideas

*Felix Zulauf, Abby Joseph Cohen, Brian Rogers, and Scott Black share their best investment bets in this week’s Roundtable installment.*

By LAUREN R. RUBLIN
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Barron’s 2015 Roundtable Part 1

If you’re looking for raging bulls or rabid bears, you’ve come to the wrong section of this esteemed publication. But if you’re seeking ways to make sense of perplexing economic times, and money in a market that offers slimmer pickings than in recent years past, stay right where you are.

Clockwise from top left: Scott Black, Brian Rogers, Abby Joseph Cohen, and Felix Zulauf. From Chicago to Singapore, the Roundtable panelists see opportunities to win at the investment game. *Photo: Brad Trent for Barron's*

The great big picture -- global economics, interest rates, currencies, politics, and markets -- was the focus of last week’s Roundtable issue, the first of three to distill the daylong conversation of the 10 Wall Street seers whom we convened in New York on Jan. 12. In this week’s installment, panelists Felix Zulauf, Abby Joseph Cohen, Brian Rogers, and Scott Black put their mettle to the pedal to drive home the case for specific investment ideas. None expects a year of robust stock-market gains; indeed, Felix looks for U.S. stocks to correct by 15% or so in the first half of 2015. Hence, the urgency of finding companies likely to outdistance the crowd through savvy management and shareholder-friendly maneuvers.

Felix, who runs money for two Swiss investment firms, is the odd duck in this week’s lineup, but we mean that only in the most affectionate way. He’s no stockpicker, but rather a tactical trader at home in nearly every asset class, who can explain eloquently not only when to buy gold or short currencies, but why. For the record, he expects long-term U.S. Treasury bond yields to keep heading south, and calls an interest-rate hike “off the table” for 2015.

Abby, head of Goldman Sachs’ Global Markets Institute, travels the world, observing and advising. When she returns home, or at least to her Roundtable perch, she comes armed with practical insights about business and economics, and a bevy of stocks favored by Goldman analysts that embody her macro views. This year she’s especially bullish on companies that will benefit from cheaper oil and rapidly rising spending on cybersecurity.

Brian captains a big ship known as T. Rowe Price, but remains surprisingly well-informed about the goings-on in other companies’ boardrooms and balance sheets. An optimist by nature, he favors concerns that have gone astray in various ways, but could soon get themselves and their beaten-down shares back on track. General Electric [ticker: GE] and Mattel [MAT] are two that fit the bill.

Scott Black, founder and boss of Boston’s Delphi Management, builds his brief for stocks meticulously, by modeling all the relevant financial data. One could learn a lot by listening to his dissection of an income statement. We learned, for instance, why he favors Viacom [VIAB] and a nifty small bank with big ambitions.

Want to know more? Please read on.

*Barron’s: Felix, we hope you’ve brought us some winning ideas today.*

**Zulauf:** I am re-recommending the iShares 20+ Year Treasury Bond exchange-traded fund [TLT], which I recommended last year. The world economy is slowing. The deflationary process is gaining traction, and the commodity cycle remains bearish. The pressure on bond yields is to the downside. The yield on the 30-year Treasury is at 2.53%, near its 30-year low. I expect the 30-year bond to break that low decisively, and yield 2% or even less than 2% when the stock market sells off. The major stock-market indexes are in for a correction of 15%. Large-cap stocks are overvalued.

*What will spark a correction?*

**Zulauf:** Earnings estimates will come down. The dollar is strong against foreign currencies, and foreign earnings will be weaker than the market expects. I am looking for a big selloff, probably in the first half of the year. During that selloff, the TLT will rise dramatically and the yield will fall sharply. When that happens, I will sell the ETF. I sold it in mid-October when the stock market fell sharply and bond prices spiked up, and I bought it back shortly thereafter.

The TLT is the biggest position in my portfolio, by far. U.S. bond yields are the highest in the world. Italy’s 10-year bond yields 1.9%. Spain’s yields 1.7%. France is at 0.8%, and Germany is at 0.49%.

The U.S. bond market is mispriced, and that will change as soon as the market accepts that the U.S. economy is slowing, not accelerating.

**Cohen:** It is not the U.S. that is mispriced, but rather those other markets.

**Zulauf:** The others are mispriced, too, but it is a relative world. I don’t know what the right price is.

I’m just saying that U.S. bond yields have more to go on the downside.

**Gross:** If European bonds are mispriced, would you short them?

**Zulauf:** I wouldn’t short them yet, although yields are close to the lows, because the European Central Bank is likely to enter the market soon and buy 500 billion euros of government paper, driving yields down further. I don’t want to go against the central bank. [The ECB launched a €1 trillion-plus bond-buying program Thursday.]

If I saw serious fiscal-stimulus programs in European countries, I would short their bonds, but that isn’t the case yet.

*When do you expect the Federal Reserve to start raising interest rates?*

**Zulauf:** A Fed rate hike is off the table because the U.S. economy will disappoint. The Fed will postpone its plans to raise rates this year. Perhaps it will do so in 2016. I don’t see how the Fed can justify hiking rates when economic growth will disappoint, employment growth will fade, and inflation will overshoot on the downside.

My next recommendation is to buy the U.S. dollar. The dollar was strong against every major currency in the world last year. That hasn’t happened in at least 25 years.

Mainstream economists are telling us that the dollar is strong because of growth differentials among countries, and an impending interest-rate hike in the U.S. They don’t understand the true reasons for the strong dollar.

*Enlighten them, and us, please.*

**Zulauf:** The Federal Reserve, under [former chairmen] Alan Greenspan and Ben Bernanke, pursued a monetary policy that kept interest rates too low. It weakened the U.S. currency, which became a funding currency around the world. Corporations issued dollar-denominated debt. According to the Bank of International Settlements, there is $9 trillion of dollar-denominated debt outstanding in the private sector around the world. That is the short position. Whatever the reasons for the recent firming of the dollar, the true firming eventually will occur when all issuers of dollar-denominated debt see their liabilities rise. They will have to hedge their positions and buy dollars, creating demand for the dollar.

Felix Zulauf: “The world economy is slowing...The pressure on bond yields is to the downside.” *Photo: Jenna Bascom for Barron's*

At the same time, the current account deficit of the U.S., which is the way the U.S. supplies dollars to the rest of the world, has been shrinking in recent years. Therefore, there is a diminishing supply of new dollars. At some point this year, the market will realize that interest-rate hikes in the U.S. are off the table. When that happens, the dollar will have a correction. I expect that correction to start in the first quarter and end before midyear. Then, the dollar will strengthen again, probably into late 2016. I don’t want to buy U.S. dollars at today’s level, but an investor who wants to establish a dollar position should do so in phases as the dollar corrects.

*What is the best way to bet on the dollar?*

**Zulauf:** You can do it in different ways. You can buy the U.S. Dollar Index, which is listed as a futures contract. [It measures the value of the dollar against a basket of foreign currencies]. You can also buy the dollar and short individual currencies. I recommend buying the dollar and shorting the Singapore dollar, which is perceived as a sound and strong currency. Within Asia, other economies have been burdened by the devaluation of the Japanese yen, including the Singapore economy, which is closely connected to China through trade. The Singapore banking system is extended; the loan-to-deposit ratio is about 120%.

**FELIX ZULAUF’S PICKS**

| Investment / Ticker | Price 1/9/2015 |
|---|---|
| iShares 20+ Year Treasury Bond ETF / TLT* | $131.07 |
| U.S. Dollar Index Future (Mar. ’15)** | 92.15 |
| Buy U.S. dollar / Short Singapore dollar** | $1=S$1.33 |
| Market Vectors Gold Miners ETF / GDX*** | $20.71 |
| Gold (spot, per ounce)*** | $1,223.25 |
| Market Vectors Retail ETF / RTH**** | $72.05 |

*Sell after stock-market correction. Zulauf expects the U.S. stock market to correct by about 15% in the first half of the year.

**Buy in phases as the dollar corrects.Zulauf expects the dollar to correct in the first quarter and then rally into late-2016.

***Hold only until the middle of 2015.

****Buy after U.S. stock-market correction.

*Source: Bloomberg*

Investors bought Singapore dollars because they believed the Singapore monetary authority was pursuing a gradual strengthening of the Singapore dollar. Singapore has a policy of matching its currency to a basket of currencies, although it doesn’t disclose which currencies they are. The Singapore government is one of the best in the world.

Now, however, values in Singapore’s real-estate market have fallen sharply. Singapore must choose whether to provide more liquidity to the financial system or fix its currency to other currencies. It can’t do both at the same time. The world hasn’t yet realized that Singapore is changing from a currency to a liquidity target. That means the government will have to weaken the Singapore dollar. The Singapore dollar will lose some of the glamour it had in recent years, and shorting it is a good way to play the strength of the U.S. dollar and the weakening of other currencies.

*Where is the Singapore dollar trading?*

**Zulauf:** It traded down from 1.70 Singapore dollars to the U.S. dollar to S$1.20 in the summer of 2011, and has traded sideways since then in a range of S$1.20 to S$1.30. Recently, it broke above that range and moved up to S$1.34. It now trades at S$1.33. If I am right that China will continue to slow and the world economy will weaken further, Singapore, like nearly all other Asian economies, will need to become more expansive in its monetary policy. Singapore will celebrate the 50th anniversary of its statehood in August. It doesn’t want to have major real-estate problems then, and will provide the necessary liquidity. Going long the U.S. dollar and short the Singapore dollar is a two-year trade.

**Faber:** I disagree somewhat about the outlook for the Singapore dollar, although I don’t disagree that the government has embarked on a policy of lowering its value. There was a huge speculative bubble in Singapore real estate. The government implemented measures in some areas to cool real-estate prices. They have fallen 30% or 40% from the peak in places like Sentosa Island, but that is after they went up about 20 times.

Real-estate inflation is a problem in Singapore and many countries as a result of increased financial liquidity. Ten or 15 years ago, Hong Kong and Singapore were reasonably priced, or inexpensive. Today, prices are so high that there is social unrest. Ordinary people’s salaries aren’t going up, but the cost of living has risen greatly.

2015 Roundtable Panelists

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The Singapore government has tried to lower the value of the Singapore dollar to make the country more competitive, more attractive to tourism, and so forth. But the economy is still in good shape, and Singapore’s banks are some of the strongest in the world. Yes, they have exposure to China. But they also have exposure to Singapore and other Asian countries. I am not that negative about the Singapore dollar. It might go down somewhat from here, but there are other currencies that are much weaker.

The Hong Kong dollar was undervalued, relative to the Chinese renminbi. This created a huge boom in Hong Kong, but with the U.S. dollar strengthening, there is an adjustment process. The Hong Kong dollar won’t be devalued against the U.S. dollar unless the Chinese renminbi really goes down against the U.S. dollar.

**Roundtable Report Cards**

[2014 Roundtable Report Card](#)

[2014 Mid-Year Roundtable Report Card](#)

Most members of the Barron’s Roundtable are active money managers who trade their positions

**Zulauf:** I don’t disagree with much of what you said. However, Singapore and its banking system are closely tied to China these days, and China is weakening. If the U.S. dollar strengthens, countries like Singapore, with current account surpluses and low interest rates, could be the first to see a weaker currency. Sicker and weaker economies will suffer later.

and change their investment opinions as market conditions warrant. For those keeping score, here’s how our panelists’ 2014 picks and pans performed through Dec. 31.

When the dollar corrects in the first half of the year, there will be a rally in gold, although it won’t last all year. In the past few months, gold has withstood the strengthening of the dollar, and put in a bottom for a good rally. Bullion could rally about 10% into the middle of the year. Then, I will exit gold. You can also invest in the GDX, or Market Vectors Gold Miners ETF. This isn’t the beginning of a sustainable multiyear run in gold; it is a trade into the middle of this year.

**Black:** Why would gold rally if inflation is close to zero in the euro zone, and 1.4% in the U.S.?

**Zulauf:** Gold is a protection against extreme deflation, as well as inflation. It is protection against systemic risk.

**Schafer:** Felix, don’t people also own gold as a hedge against currency risk?

**Zulauf:** Yes. Gold has been a fantastic currency. Last year, it was the second-strongest currency, after the U.S. dollar. It has risen against all other currencies and has fulfilled its function to protect against currency debasement.

**Gross:** If real interest rates come down, as you expect, won’t that push the gold price up?

**Zulauf:** Historically, falling interest rates have been a plus for gold, but that has always been in times of inflation. Now the risk is toward deflation. Gold doesn’t pay any interest, and there is a minimal cost to hold it. It is more attractive to hold gold in a world of zero interest rates than when rates were 4% or 5%. Gold could run to the mid-$1,300s from today’s $1,223.

Once the U.S. stock market corrects, I would also buy the Market Vectors Retail ETF (RTH). U.S. retailers benefit from a stronger dollar, as it allows them to buy foreign goods at cheaper prices and expand their profit margins. The ETF’s three largest positions are Wal-Mart Stores [WMT], Home Depot [HD], and CVS Health [CVS]. Retailing stocks have always been among the best performers when the dollar has strengthened considerably.

*Thanks, Felix. Abby, what do you favor this year?*

**Cohen:** From an asset-allocation standpoint, 2015 will be a better year for U.S. equities than bonds. It is possible that the Fed will wait even longer to raise interest rates because of its concerns about the impact of a strong dollar, the deflationary consequences of falling energy prices, and so on. Nevertheless, equities are more attractively valued than fixed-income assets. My suggestions presume that the economy continues to grow.

Many parents in this room might recognize the name Carter’s [CRI]. The company sells a variety of apparel and other products under the Carter’s, OshKosh, and other brands, for children from birth through about age 12. It sells through a variety of channels, including its own stores, a Website, department stores, and discounters. Carter’s was founded in 1865. It is a North America-centric company; the U.S. accounts for 89% of sales; Canada, 7%, and the rest of the world, 4%.


Abby Joseph Cohen: “FedEx benefits significantly from online shopping, which is here to stay.” *Photo: Jenna Bascom for Barron's*

Carter’s could face moderating costs, including the cost of cotton, which represents 15% of its cost of goods sold. Cotton prices have fallen about 30% from their high last spring. The company also is benefiting from a strong dollar, as some of its products are sourced outside the U.S. Carter’s will soon exit a period of heavy investment in its Website and stand-alone stores. Selling, general, and administrative expenses are expected to fall.

Also, U.S. birth trends have improved. We haven’t seen a new baby boom yet, but the baby dearth seems to be ending. Carter’s has a 20% share of the apparel market for children two years and under.

*Has the company been growing?*

**Cohen:** Yes. The stock is rated Buy by Goldman’s analyst, who is forecasting annualized sales growth of about 9% in the next couple of years, and a return on equity of 23%-25%.

Carter's is generating strong free cash flow, and a number of retailers are telling us they are seeing good demand for its products in their stores. Our analyst estimates that the company will earn $5.10 a share this year, notably above the consensus of $4.58. The price/earnings ratio is 16.6, based on Friday's [Jan. 9] close of $84.81. The shares trade for 22 times last year's estimated earnings, so earnings growth is an important part of the story.

My next few stocks are beneficiaries of the decline in energy prices. FedEx [FDX] provides transportation and business services, typically in the form of shipping, delivery, and package freight. The company's freight division operates 62,000 ground vehicles, and energy costs are a substantial portion of its cost of goods sold. FedEx executed well during the holidays, its peak shipping season. It benefits significantly from online shopping, which is here to stay, and there has been a shift in its business mix.

*How so?*

**Cohen:** For a while, there had been a shift away from so-called priority shipping toward cheaper forms of shipping. Now there is a shift back to more expensive forms of shipping, which is good for profit margins. It could enhance FedEx's margins by three percentage points in the next three to four years. Our analyst estimates that FedEx's earnings CAGR [compound annual growth rate] could be substantial in the next few years. Goldman has a 2015 earnings estimate of $9 a share, versus the consensus estimate of $8.98. The shares sell for 19 times estimated earnings.

**ABBY JOSEPH COHEN'S PICKS**

| Company / Ticker | Price 1/9/2015 |
|---|---|
| Carter's / CRI | $84.81 |
| FedEx / FDX | 172.66 |
| Quest Diagnostics / DGX | 68.39 |
| Acuity Brands / AYI | 151.5 |
| Siemens / SIE.Germany | € 93.10 |
| Palo Alto Networks / PANW | $125.82 |

*Source: Bloomberg*

On the negative side, the stock has been a strong performer in recent months, and is already owned by a number of big U.S. mutual funds.

**Black:** FedEx has a pristine balance sheet.

**Cohen:** My next pick, oddly enough, also benefits from the decline in crude prices. It is Quest Diagnostics [DGX]. Quest has a 26% share of the independent laboratory market in the U.S. It is the low-cost provider of blood-testing services. It also does work for pharmaceutical companies. Ultimately, the Affordable Care Act will be a net positive for Quest. The company's volumes are rising organically, and it has been active in making acquisitions, leading to a growing market share. In the current and coming health-care environment, it is good to be the low-cost provider with substantial volume growth.

Quest also has several growth initiatives. It offers drug monitoring for pharmaceutical companies. It is also involved in what it calls esoteric testing, including genetic and other specialized testing. This work tends to have higher profit margins.

*What is the connection with lower energy prices?*

**Cohen:** Quest operates 2,000 patient locations. It transports fluid samples for testing. It also produces much of the material it uses, including plastic tubes made of oil-based resins. Labs and services has been the worst-performing subsector of the health-care sector in the past year or two. It is possible portfolio managers will look to rotate into it.

In addition, Quest's size makes it easier for the company to absorb some of the regulatory costs that have been imposed on the industry.

Quest is opening a new facility in Massachusetts that will give it more geographic reach. The company has a free-cash-flow yield of about 9%, and might be able to lower its costs further. Our analyst estimates 2015 earnings of $4.68 a share, versus the consensus view of $4.40. The stock yields 1.9%.

My next name is Acuity Brands [AYI], a major provider and distributor of LED lighting.

**Black:** That's the old Lithonia Lighting, which was owned by Erwin Zaban's National Service Industries.

**Cohen:** That's right. Acuity works primarily through electrical wholesalers. As Scott indicated, it sells a number of lighting brands. We are seeing enormous demand for LED lighting, particularly in new construction and industrial projects. Many individuals and companies are finding LED lights well worth the upfront cost, as they consume electricity far more efficiently than less expensive incandescent lights.

LED bulbs don't need to be replaced as frequently, either, so they offer labor savings. LED lighting is a higher-margin business for Acuity than traditional lighting.

Here are the numbers: Our analyst estimates Acuity will earn $5.49 a share in the fiscal year ending in August. The consensus is $5.36. The price/earnings multiple isn't low at 28 times, but gross profit margins of 42% are impressive.

Acuity's LED lighting sales were up 75% in fiscal 2014. Even though sales of traditional lighting are declining, overall sales rose 13%. LED lighting accounts for 42% of sales.

Siemens [SIE.Germany], my next stock, is a beneficiary of a rising dollar. The company is based in Germany and was founded in 1847, proving that it isn't only companies founded in the past five years that provide interesting things.

Siemens is a conglomerate; it has businesses in electronics and electrical engineering, gas power, electric utilities, wind power and other energy renewables, building technologies, such as fire safety, security, and automation, and more.

Siemens also has financial activities. One attraction is that the company is pruning its portfolio. The stock hasn't performed well. It has underperformed its sector and yields about 4%.

**Schafer:** In what currency?

**Cohen:** That’s in euros; I was referring to the German shares. Siemens also trades in the U.S. via American depositary receipts [SIEGY].

Our earnings estimates aren’t much different than the consensus, but we are interested in how the company will address its diversified portfolio of business activities. Eighteen percent of current contracts are unprofitable. Total sales were flat in 2013 and 2014. We forecast that they will be up just a smidgen in 2015. As Siemens begins to rationalize its operations, the stock could become more attractive. The company will also benefit from the decline in the euro, relative to the dollar.

**Zulauf:** Siemens has been a disappointment for as long as I can remember. The former CEO was ousted, and the chief financial officer took over. He is trying to slim down the company and increase profitability. It might work; there is enough waste to cut. But it is difficult to cut out the fat in some European countries, due to labor laws.

**Herro:** Do you have earnings-per-share estimates for Siemens?

**Cohen:** We estimate that Siemens could earn 7.12 euros in 2015. It could earn €7.69 in 2016. The stock is trading at €93.10.

My last name is in the technology sector, which has performed well. It is Palo Alto Networks [PANW], a specialist in cybersecurity.

*How timely. It seems that ISIS has just hacked the Twitter account of the U.S. Central Command.*

**Cohen:** We are all learning the importance of cybersecurity. Palo Alto provides an enterprise-security platform, including firewalls. It also sells subscriptions to software products that protect against malware.

We surveyed hundreds of companies around the world, asking how they plan to spend their 2015 IT [information technology] budgets. Cybersecurity was the No. 1 target by far for accelerated IT spending. Beneficiaries will include some of the big data-management companies, and specialty concerns, such as Palo Alto. The U.S. Department of Justice recently advised that companies need to pay more attention to cybersecurity at the board and chief-financial-officer level. Many companies need to update their firewalls.

Palo Alto’s results were above consensus forecasts for the past few quarters. Forecasts have been moving higher. We expect the company to earn 74 cents a share this year. The company’s business has been largely domestic, but management is planning to move into other parts of the world. Palo Alto has a new partnership with a company that will give it more distribution flexibility. We see good top-line growth and better operating leverage, although we have some concerns. Everyone knows that cybersecurity is important, so large companies such as Cisco Systems [CSCO] and Juniper Networks [JNPR] are trying to move into the area. Also, the stock has doubled in the past 12 months.

**Black:** And it trades for 115 times this calendar year’s expected earnings.

**Cohen:** Palo Alto’s fiscal year ends July 30. We are not saying that it is a cheap stock, but that there is a possibility that profit margins and revenue growth will continue to outperform.

**Black:** I recently visited Check Point Software Technologies [CHKP] in Silicon Valley. It has much greater penetration of big companies and government agencies than Palo Alto. If you back out its $19 a share of cash, Check Point sells for 15 times earnings, well below Palo Alto’s multiple.

**Cohen:** Palo Alto is a cybersecurity pure play.

**Rogers:** There aren’t too many plays in this business.

**Gabelli:** Palo Alto has built up a sales force and is doing extremely well on new conquests. I don’t own any of the stock; it is not my core competency. But it is a good story.

**Black:** You know the old joke: We’re not here to buy stories, we’re here to buy businesses. This is an overpriced business.

**Rogers:** To each his own.

*Well said, Brian. Let’s get your ideas.*

**Rogers:** I have nothing selling for 115 times earnings. To put my stocks in context, I believe it will be harder to make money in 2015 than in 2014. Relative valuation will be important. Income could be important. The market might well have the correction that Felix talked about, but between now and the end of the year, it could reward companies that perform well fundamentally with reasonable returns. It is going to be a volatile year. I am looking at companies that have had performance issues and therefore are relatively inexpensive. Our bet is one of mean reversion.

Brian Rogers: Boeing’s cash flow will exceed earnings for a couple of years. *Photo: Jenna Bascom for Barron's*

Boeing [BA] is one of the world’s best companies. The stock was down 5% last year, but up a lot the year before. The shares are selling for $131, and the company will probably earn $8.75 a share this year. It sells for 15 times earnings. Boeing and its chief competitor, Airbus Group [AIR.France], are serving a steadily growing marketplace. Even going back to 2001-’02, the commercial airliner business has been flattish to growing slightly. It never had a major downdraft. And Boeing is the industry leader, with good secular growth and a decent valuation. Something interesting is going to happen here regarding cash-flow conversion.

*Something positive, we presume.*

**Rogers:** Yes. Boeing capitalized development expenses on the 787 Dreamliner. Now that the company is starting to deliver so many 787s, cash flow will exceed earnings for a couple of years. As deliveries of the 787 continue, cash expenses per unit will be much lower than accounting costs per unit. Once Boeing reaches the tipping point in deliveries, cash flow will really start to grow.

How do we know this is happening? Let’s look at Boeing’s dividend history. In December 2013, the company surprised investors with a 50% dividend increase. This past December, it blew the market away again with an above-consensus dividend hike of 25%. The company now pays a dividend of $3.64 a share, yielding 2.8%. Boeing has a nine-year backlog on the 787. It is going to be in business for a long time.

The company is aggressive about returning cash to shareholders not only through dividends, but also through stock buybacks. Boeing bought back about $6 billion of stock last year and has a continuing buyback authorization.

There is a lot of debate about whether the drop in oil prices is good or bad for the company.

*What could be bad?*

**Rogers:** Bears would say that with the price of oil going down, no one buys new fuel-efficient planes. At the same time, lower oil prices make for a much stronger airline industry.

Abby recommended Siemens today. The American version of Siemens is General Electric. Abby said Siemens is reshuffling its portfolio, and GE is undergoing a similar reshuffle. It took Synchrony Financial [SYF] public last year and will spin off the rest of that company toward the end of 2015 in a stock swap. GE yields 3.8%. After the company disposes of the rest of Synchrony, it will own a group of mostly industrial businesses generating 70% or 75% of revenue. These arguably are higher-multiple businesses than financial services.

**BRIAN ROGERS’ PICKS**

| Company / Ticker | Price 1/9/15 |
|---|---|
| Boeing / BA | $131.54 |
| General Electric / GE | 24.03 |
| Hess / HES | 71.12 |
| Loews / L | 40.05 |
| Mattel/MAT | 29.1 |
| Vulcan Materials / VMC | 68.29 |

*Source: Bloomberg*

GE currently trades for $24 a share. The downside is probably $22, plus the dividend. If you put a multiple of 18 times on industrial earnings, which isn’t too high for a world-class business, and a multiple of 12 on the remaining financial-services business, you end up with a $29 stock. GE is a way to do reasonably well in what could be an uninspired market.

**Cohen:** Brian, what is the catalyst for GE?

**Rogers:** The company is reducing its financial-services exposure. The shares could be re-rated upward, based on the remaining higher-quality, higher-multiple industrial businesses.

*What is the outlook for dividend growth?*

**Rogers:** GE increased the dividend in December. It now pays 92 cents a year. At some point in the next 18 months, we will probably see a dividend of a dollar a share, which would support a $30 stock price.

*Is currency a head wind for GE?*

**Rogers:** It is a bit of a head wind, but we have built that into our estimate of $1.75 a share in earnings for 2015.

Next, given the selloff in energy stocks, you have to own an energy name. My pick is Hess [HES]. The stock previously traded above $104 and is now in the low $70s. Hess has undergone a transformation in the past few years, after Elliott Management launched a proxy battle. The board was restructured to include people from Elliott’s slate. For a CEO whom investors doubted, all I can say is, John Hess has gotten religion.

The company has been pruning its portfolio. You’ve got to love a company that sold its Russian business two years ago for $2 billion. Today, it would be worth only $1 billion. Hess has pruned about $8 billion in assets. It has become serious about capital allocation, and has taken the share count down by repurchasing $4.7 billion of a $6.5 billion buyback authorization. The company has raised its dividend by 150%. It is in an interesting resource position. Having sold many of its old businesses, it is now concentrated in the Bakken and Utica shale formations. It is an energy exploration-and-development pure play. The company has shed its terminal business and its gas stations.

*Does it still make Hess toy trucks?*

**Gabelli:** If you want a Hess truck, you’ll have to buy it online.

**Cohen:** That is another plus for FedEx.

**Rogers:** Hess has cleaned up its balance sheet and took its debt down to $5.7 billion from $8 billion two or three years ago.

**Gabelli:** I have to say this: That’s the good side of investor activism.

**Rogers:** Mario, you’re right. Everyone would have to agree that the company is in a better place today because of the proxy battle. In a sector under tremendous siege, Hess seems like a high-quality, well-managed, financially safe company that has cleaned up its act. Recent estimates have put the company’s valuation at $100 to $105 a share, compared with an asset value of $135 last summer. It shows you how quickly things can change.

**Black:** The Bakken isn’t profitable with oil selling at $50 a barrel. I just sold all my Bakken plays. How do companies operating in these areas make any money at current oil prices?

**Rogers:** I concede that forecasting earnings per share is virtually impossible.

My next idea is Loews [L] -- not the retailer but the holding company. It has a shareholder-friendly management team and owns lots of interesting assets. Every sector in which Loews operates is under siege, except for the hotel business. Loews offers exposure to CNA Financial [CNA], the insurance company, which is a well-run business that trades for a moderate multiple. Loews also owns majority stakes in Diamond Offshore Drilling [DO] and Boardwalk Pipeline Partners [BWP]. Then there’s the Loews hotel chain, and about $5 billion of net cash.

When you work through the numbers, each share reflects two-thirds of a share of CNA, 0.19 of a share of Diamond, 0.35 of a share of Boardwalk, $5 of the hotel business, and about $9 of net cash. That is a $51-a-share pool of assets, for shares selling at $40. The Tisch family owns 21% of the company. Loews has bought back 70% of its shares in the past 40 years. No one will claim that the value of CNA or Diamond Offshore is at peak levels, so there are a few ways to win here. The company could continue to buy back shares. You are making a bet on the capital-allocation decisions of CEO Jim Tisch and his family. Loews, by the way, has lagged the Standard & Poor’s 500 index in each of the past five years, so there is the possibility it will revert to the mean and advance.

*Hasn’t the stock always carried a conglomerate discount?*

**Schafer:** It has always traded at a discount to the underlying asset value, but Jim Tisch has done a great job.

**Witmer:** I agree, especially when it comes to buying back shares.

**Rogers:** My next pick was a Murphy’s Law stock for us in 2014. Anything that could go wrong did go wrong. Now, it sells at a price that the rest of you can afford. I am talking about Mattel, which fell 35% last year. As a shareholder, I didn’t see the trouble coming. Sales are expected to be down 8% but up a bit at the retail level. The company has been liquidating inventory.

Mattel has great product lines, including Barbie, Fisher-Price, Hot Wheels, and American Girl. Earnings are under pressure, and will probably fall from $2.58 a share in 2013 to a $1.80 in 20l4. They could rebound to $2.30 in 2015. The stock sells for $29. Mattel has a $9.7 billion market cap. Sentiment on the stock is awful; more than a dozen analysts follow the company and there is only one Buy rating. We see downside to $25. The company pays a $1.52 dividend and yields 5%, which I would assume is 75% safe. If the dividend holds and earnings rebound to $2.30 in 2015, you could see a total return of 30%. Mattel isn’t for the faint of heart. But the company is financially strong, so it is unlikely to get into much more trouble than it already has.

*What could drive earnings higher?*

**Rogers:** Cost-cutting is a big part of it. The company will probably cut selling, general, and administrative expenses, as a result of a recent acquisition. We hope there will be a restocking of the Barbie line in the next year. Mattel is losing a Disney contract, which will hurt in 2016, but the company has a lot going for it.

**Black:** Didn’t Mattel miss the secular shift among young people from toys to electronic games?

**Rogers:** To some degree, yes. My last pick is Vulcan Materials [VMC].

**Gabelli:** I owned that one.

**Rogers:** We have all owned it from time to time. Vulcan is the largest producer of aggregates in the country. Its business has a south-central and southeastern tilt. Shipments are down roughly 50% from the peak in the mid-2000s. Interestingly, Vulcan has never experienced a price decline in its aggregates business. The company tries to co-locate its rock and aggregates facilities in key markets because it is expensive to ship concrete and gravel and sand. Vulcan is a bet on a continued recovery in the Southeast. It is also a bet on a potential new highway-funding bill, since spending on roads has fallen a lot. The stock sells for $68. It was up 10% last year, the best performer among my current picks. The company doesn’t pay much of a dividend; it yields 0.4%.

Vulcan has a lot of upside leverage. We expect the company to earn $2.58 a share in 2015. Earnings could rise to $5.10 in the next few years. The stock sells for about 10 time cash flow.

The company has irreplaceable sites, and thus a big moat around its business, to employ one of Warren Buffett’s favorite phrases. Vulcan faced head winds for five years after the financial crisis. It is now positioned to benefit from tail winds. A new management team led by Tom Hill is doing many positive things. Full disclosure: T. Rowe Price owns 13% of the shares.

*That’s conviction. Thank you, Brian. Let’s move on to Scott.*

**Black:** We are moderately constructive on the stock market, although I agree with Meryl that it is increasingly difficult to find a lot of cheap stocks. I have a handful here that might be OK. My first stock, and my only large-cap today, is one that Mario has owned forever. It is Viacom. The company has two divisions. Media networks accounts for 73% of revenue, but contributed 95% of last year’s operating income. The filmed-entertainment unit, which includes Paramount Pictures, contributed 27% of revenue last year, but only 5% of operating income.

Scott Black: There aren’t many quality media companies selling for Viacom’s inexpensive 11.5 times earnings. *Photo: Jenna Bascom for Barron’s*

Viacom’s cable-TV networks include MTV, MTV2, VH1, CMT, Nickelodeon, Spike, and so on. Most reach up to 95 million homes. Viacom has 11 of the top 50 cable networks. It has eight of the top 30 that reach the best age demographic -- 18 to 49. Seventy percent of their MSO [multiple-system operator] fees are locked in for the next three years, with built-in escalators.

*Explain that, please.*

Those are the fees Viacom receives from cable-TV providers and other content distributors. You can’t guarantee the theatrical business, but Viacom is trying to cushion results with animated movies. Animation has a big release planned with *Monster Trucks*. Recent and planned films include *Selma*, *Project Almanac*, *Mission Impossible V*, with Tom Cruise, and *Terminator Genesys*, in which Arnold Schwarzenegger has a cameo role.

Viacom CEO Philippe Dauman notes that the Nielsen ratings don’t capture the new market, or viewership of movies and TV shows on handheld electronic devices. He is right about that, although new services are starting to measure this market, which could help Viacom’s ratings.

The shares closed recently at $71.67. Viacom has 422 million fully diluted shares, and a $30 billion market capitalization. It pays a dividend of $1.32, and yields 1.84%. We estimate that network revenue will rise 5% in the year ending in September, to $10.68 billion. Filmed-entertainment revenue could rise 10%, to $4.1 billion. After eliminations, we put total revenue at $14.66 billion, operating income at $4.339 billion, and profit before taxes at $3.75 billion. Add $60 million of equity interests, apply a tax rate of 33%, and you get net income of $2.55 billion.

*What is that on a per-share basis?*

**Black:** Viacom has an ongoing stock-buyback program. In the past three years it repurchased $11 billion worth of shares. It still has a $6.24 billion authorization. We estimate that the company will spend $2 billion to buy back 28 million shares this year. That gets us to an average of 408 million shares, and earnings per share of $6.25. Wall Street’s estimate is $5.97. The stock is selling for 11.5 times estimated earnings. There aren’t many quality media operations selling at that sort of multiple. Based on enterprise value to projected Ebitda [earnings before interest, taxes, depreciation, and amortization], Viacom is selling at a multiple of about nine. Walt Disney [DIS] has an EV/Ebitda multiple of 12, and most other media companies are between 11 and 12.

**SCOTT BLACK’S PICKS**

| Company / Ticker | Price 1/9/2015 |
|---|---|
| Viacom / VIAB | $71.67 |
| Microsemi/MSCC | 28.02 |
| Customers Bancorp / CUBI | 18.25 |
| Ares Capital / ARCC | 15.84 |

*Source: Bloomberg*

Viacom’s free cash flow and earnings are about the same. Return on equity will be 59% this year, and return on capital, just over 14%. The company is levered about 3.1 to 1. The interest coverage ratio [earnings before interest and taxes, divided by interest expense] is 7.8 times. You can’t pencil in how Paramount will do, but you don’t have to worry that Viacom’s buybacks are imperiled.

**Witmer:** What percentage of revenue does Paramount contribute?

**Black:** The company doesn’t break out those numbers. It is pretty small. I’ve been conservative in using 5% top-line growth for the media networks. With Viacom’s acquisition of Britain’s Channel 5, network revenue could rise 6% or 7% this year.

**Witmer:** The stock is down from the $80s.

**Gabelli:** The big question is: What will happen to the A shares, the voting shares, when Sumner Redstone [Viacom’s founder and controlling shareholder] passes?

National Amusements, which he controls, owns 40.5 million of the 50 million A shares. Redstone is still spirited, even at 91, but what would Dauman do if Redstone’s estate or National Amusements were seeking liquidity and wanted to sell Viacom? Speaking for my church, how do you protect the other A-class shareholders if a buyer doesn’t give them the same price that it offers National Amusements?

**Witmer:** Is there protection for minority shareholders? Consider what is happening at Sika [SIK.Switzerland], the Swiss adhesives company.

**Gabelli:** Another company [ Compagnie de Saint-Gobain (SGO.France)] is trying to buy Sika’s controlling family’s stock at a premium, squeezing the other shareholders.

**Black:** My next company, Microsemi [MSCC], was once looked upon as a semiconductor supplier only to the U.S. Defense Department. The P/E multiple is low because that is still the perception, although it isn’t accurate. In 2010 mixed-signal chips contributed 29% of revenue, and discrete components, 71%. The mix has changed dramatically since the purchase of Actel. Mixed-signal now generates 26%; discretes, 32%, and field programmable gate arrays, 24%. Last year, Microsemi bought Symmetricom, a leader in timing for network virtualization, which is now 18% of the business.

*Who are Microsemi’s other customers?*

Telecom companies account for 36% of revenue; defense and security clients, 27%, commercial aerospace outfits, 14%, and the industrial sector, 23%. Geographically, only 14% of revenue is exposed to Europe. U.S. and Asian revenue is dollar-denominated. The stock is $28.02. There are 95 million shares outstanding, and the market cap is $2.66 billion. The company doesn’t pay a dividend.

Much of the discussion at this year’s Roundtable concerned oil prices, interest rates, currency wars, and the troubled outlook for Europe. The group met Jan. 12 in New York. *Photo; Jenna Bascom for Barron's*

Minimally, revenue will rise 10% in the fiscal year ending Sept. 30. That’s 8% unit growth, and 2% from the Symmetricom acquisition. Profit before taxes could total between $266 million and $281 million. The tax rate is 8%, in part because the company has about $60 million of net operating losses from prior years [NOLs offset a portion of current taxes]. We estimate per-share earnings of $2.65, against last year’s $2.19.

Excluding stock-based compensation -- which is the appropriate thing to do -- we get earnings of $2.23 and a P/E of 12.5. Return on equity is 20.3%. Microsemi has a net debt-to-equity ratio of 0.48; its return on capital is 13.7%. The coverage ratio is outstanding at 16.5. We estimate $271 million this year in free cash flow.

The valuation is reasonable, and the stock isn’t well-known.

*Good attributes, both.*

**Black:** Next, I like Customers Bancorp [CUBI], based near Philadelphia. Yes, net interest margins are getting killed with interest rates so low, but this is a special situation. Jay Sidhu built a little bank outside Philadelphia into Sovereign Bank. He left in 2006, before the Lehman Brothers debacle. He took control of Customers in 2009, when it had $350 million in assets and $22 million in equity. Now it has $6.5 billion in assets.

Customers is a wholesale bank, with just 5% of revenue from consumers. We are expecting more-controlled asset growth of 10% a year in the future. The bank’s total risk-based capital ratio is 11.2, and its capital adequacy ratio is 8%. The net interest margin is around 280 basis points [each equal to 1/100th of a percentage point], but Sidhu hopes to lift that to 300 basis points, long-term. In the next few years, he’d like to achieve a 1% return on assets and an after-tax return of 12% on equity. The bank’s efficiency ratio [costs minus interest expense, divided by revenue] is 54% and he’d like to drive it down to the mid-40% range.

*How good is loan quality?*

**Black:** We study reserves against nonperforming assets. Customers has reserved $31.1 million against loan losses, but has only $9.9 million in non-accruals. That is a coverage ratio of 3.1. Many of the bank’s loans have been made to high-net-worth families, with personal signature guarantees. The company also warehouses loans [extends short-term lines of credit] to mortgage brokers. The mix of loans is 39% for multi-family dwellings, 20% for owner-occupied commercial and industrial construction, 10% for non-owner-occupied commercial real estate, 8% consumer loans, and 23% warehousing.

Customers has a great idea for gathering new funds -- BankMobile, a mobile and tablet banking platform. It has signed up 1.2 million students for the service at 800 colleges around the U.S., and taken in $250 million in balances so far. Sidhu hopes that when these customers graduate, he will convert them to customers of the traditional bank. Customers has only a handful of offices in the Northeast, from Princeton, N.J., to Boston. This isn’t branch banking. The bank has hired from places like JPMorgan Chase [JPM] and Sovereign.

*It sounds intriguing. Give us the numbers.*

**Black:** The bank could have $7.03 billion in average earning assets and $197 million in net interest income this year. We are modeling $6 million a quarter in loan-loss provisions, versus $5 million previously, because the loan portfolio is growing. Net interest income after loan-loss provisions is an estimated $173 million. Non-interest income is only about $6 million a quarter, or $24 million a year, and non-interest expense is $108 million. Thus, profit before taxes is an estimated $89 million. Taxed at 35%, that’s $57.85 million.

Divide by 27.8 million shares, and earnings per share would be $2.08. Company guidance is $1.95 to $2. Sidhu doesn’t expect to raise funds in the capital markets this year, but that might be necessary in the future to bulk up equity.

Customers is trading for $18.25. It sells at 1.19 times book value and 8.8 times earnings. Most regional banks on the East Coast sell for 12 to 14 times earnings, and many of them are under-reserved.

*Could this bank become an acquisition target?*

**Black:** Sidhu is going to build it before he sells it. He took Sovereign from nothing to a huge bank, and eventually sold it to Spain’s Banco Santander [SAN].

**Rogers:** Where does he find so many students with money to deposit?

**Black:** They direct-deposit their student loans into their online bank accounts. Ultimately, they have to pay out the money, but there are transactional balances.

My last pick, Ares Capital [ARCC], is a yield play. It is a business-development company. The shares are trading for $15.84. Ares pays a $1.52-a-share dividend and yields 9.6%. BDCs can leverage up 2-to-1 to make small-business loans. Ares stays under 0.85 to 1. Its sweet spot in loan size is $10 million to $20 million.

*How big is the loan portfolio?*

**Black:** Ares currently has a loan portfolio of $8.78 billion, and has lent funds to 205 companies. Only one of its companies, Lonestar Prospects, is tied to the energy industry; it sells sand for fracking [hydraulic fracturing of oil and gas wells].

About 38% of Ares’ loan book is unitranche debt [a hybrid of senior and subordinated debt, with a blended interest rate]. The company has a unitranche joint venture with GE. Another 23.2% is loans to the health-care industry; 17.9% is to services providers, and 11.5% is for business services. The average Ebitda margin of the companies in Ares’ portfolio is greater than 20%.

Ares grades its loans at the end of every quarter. The No. 1 category, or worst-performing loans, totaled $15.7 million, or 0.4% of the loan book, at the end of the third quarter. The second category encompassed $90.3 million, or 2.2% of loans. The company will have $1.1 billion of total investment income this year. Pretax profit could total $511 million this year. Subtract a 5% excise tax -- the company pays no income tax -- and you get $485 million.

Ares harvests capital gains from time to time, which is hard to model. It realized $40 million of capital gains in the first three quarters of 2014. Being conservative, I gave them $50 million for all of this year, taking income back up to $535 million. Divide by 314 million fully diluted shares and you get $1.70 a share. Last year, the company likely earned $1.46. The Street forecast for 2015 is $1.60. The P/E is 9.3. Book value is $16.71.

*Can you explain the tax structure in more detail?*

**Black:** Business-development companies have a pass-through tax structure. They must distribute at least 90% of their taxable income as dividends to investors. That’s why the yield is so high. They don’t buy back shares.

Ares’ portfolio looks bulletproof, and the company seems to be smart in negotiating credit lines. It pays a commitment fee of three-eighths of a percent and borrows from a consortium of more than 12 banks. Plus, you get paid while you wait for growth.

*Thank you, Scott.*


2014 Barron's Roundtable Report Card Revisions

MARIO GABELLI'S PICKS

OSCAR SCHAFER'S PICKS

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