Bargain Hunting in '14's Second Half

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It's an expensive stock market today, what with equities in the sixth year of a bull market, when the average bull lasts but 2.5 years. We've gone 32 months without a pullback of 10% or more, despite an average of just 18 months without such a dip.

Valuations are up relative to the last 50 years. The dividend yield is lower than normal while ratios such as price to earnings and sales are higher than average.

Other signs of ebullience suggest a fully valued market: Robust initial public offerings, lots of mergers, very low volatility, and little premium being paid for corporate bonds versus governments.

However, with the 10 year Treasury yielding under 2.6%, you're still incented to stay in equities, based on stocks' earnings yield of 5.2%. Any dips are likely to be met by bargain hunting.

To stay in the game, search for value while looking for superior dividends, earnings, sales and cash flow per dollar invested. Gravitate towards out of favor sectors, confident that the market's cyclicality will eventually bring the unloved back in favor. At a minimum you'll reduce the risk of overpaying.

Our picks at the year's start have performed well, up 13.9% versus a 9.1% return on the S&P 500, details below. Our second half selections follow:

1. IBM (IBM)

Big Blue's ace in the hole is its consulting division. While the latest and greatest technology provides the headiest margins, consulting's long term recurring revenues avoid the booms and busts. The brand remains top notch; even today, no one gets fired for hiring IBM.

Other important drivers remain its software and hardware businesses. IBM mainframes remain the centerpiece of many financial and telecom firms.

Valuations are attractive; the stock trades at just nine times forward earnings. IBM is committed to returning money to shareholders – the company plans to buy back $50 billion of stock and pay out $20 billion in dividends through 2015.

2. Citigroup (C)

Financials are likely to benefit from the eventual increase in interest rates as it spurs loan pricing, its key product. The cost of funds will ultimately rise too, but this is likely to lag, meaning that the spread between their cost of funds and the interest rate on their loans will stay wider for a while.

Financials are well on their way to completing bolstering capital ratios, permitting them to return more money to shareholders. Valuations remain cheap, in many cases below book value. Stock prices have not returned to pre-2008 peaks, and sentiment remains skeptical.

Citigroup's global franchise is unique. The stock is out of favor due to the turmoil involving its Mexican operations. We believe that episode is priced in, will be resolved and in the meantime you have an attractive entry point for the stock.

The stock trades at 9 times earnings and 70% of book value. A boost in the dividend could be the catalyst for a higher stock price.

3. Cisco (CSCO)

Cisco is the industry leader in routers and networking devices for access to the Internet. As the days of heady growth have waned, Cisco has embraced the mantra of returning money to shareholders.

It initiated its dividend in 2011 and has grown it by a factor of three; the current yield is 3.1%, making it one of the Dow's top ten dividend payers. Further, it has recently increased its planned stock buy backs by $15 billion. The stock's free cash flow yield is nearly 9%, and it sits on cash of nearly $30 billion, or about a quarter of its market cap.

Cisco represents an attractive combination of value and growth. A possible departure of its CEO John Chambers could also positively influence the stock, as some believe he's overstayed.

4. Avon Products (AVP)

Avon's legendary business model and brand name fell into disrepair under prior management. We are optimistic that this global marketing giant can regain its allure under the new leadership of Sheri McCoy.

The franchise's value was made clear when conglomerate Coty raised its bid for Avon in May of 2012, offering to buy all shares for $24.75. The bid was rejected by Avon on the grounds that it could perform better independently. Unfortunately, the stock is now under $15.

From the current entry point shareholders can benefit several ways. First, we think Avon has several solid initiatives to improve growth, including improving the technology infrastructure. Second, part of Avon's malaise has been the perceived slowdown in the emerging markets. We think the long term outlook for the emerging markets is generally strong. Third, Avon's battle against charges under the Foreign Corrupt Practices Act is coming to an end.

Finally, another suitor may well call upon the Avon lady, and this time there'll be less support from shareholders to reject it.

5. Rio Tinto (RIO)

London based Rio Tinto is one of the largest miners in the world, operating mines primarily in North America and Australia, extracting copper, iron, and aluminum. The stock is relatively cheap, down 60% from its all-time high, and trading at just nine times earnings.

Record amounts of monetary accommodation are entering the world's financial system to jumpstart growth. This is deemed un-harmful because inflationary pressures are low; indeed, the Europeans are worried about deflation.

Investors have taken the message of low inflation to heart, shunning the stock of natural resource stocks, reasoning that absent inflation growth prospects are muted. In addition, the decelerating growth in China, a big consumer of raw materials, has weighed on sentiment.

Rio Tinto is a contrarian pick which will ultimately prove profitable.

6. Honda (HMC)

Honda is a legendary success story, starting out in post-WW II Japan, and growing to become one of the planet's most ubiquitous brands, famous for reliability and economy if not styling. It remains well positioned to make inroads in those areas of the world where fuel efficiency and value are important.

The US will remain an important market, with the average age of our cars close to an all-time high, at nearly 12 years. Technology may well accelerate sales, as buyers look for the latest gadgets to stay connected while driving. Others are looking for break through fuel technologies, whether to reduce a carbon footprint or to cut costs, or both. Honda is likely to be on the forefront.

Valuation wise, Honda is attractive. It's been weighed down by the perception that it's Japanese, and therefore part of the stagnant Japanese economy and stock market. However, 80% of its business is outside of Japan. So, with the stock down 20% from its November high, we think that ultimately reality will trump perception, and Honda investors will profit.

7. Newmont Mining (NEM)

Exposure to precious metals may not be the most profitable holding, but it may well serve as your nest egg's insurance. Gold and silver have historically zigged when the financial markets have zagged; that proved true in the last downturn, in 2008, when Treasuries and gold both advanced amid 2008's 37% rout in the S&P 500.

Gold pays no dividend nor is it susceptible to easy valuation. One answer is to invest in gold mining companies, which do pay dividends and have earnings.

Because gold is so out of favor, in many cases gold mining stocks are trading at a discount to their reserves, even net of extraction costs.

We like Newmont for several reasons. First, it operates many mines in widely disparate areas, even continents. This diversifies the risk of political expropriation, floods, strikes, etc.

Second, not only does the company pay a generous dividend, changes in the dividend are based on changes in the gold price. That assures that profits from higher gold prices will be shared. The company has a strong balance sheet.

Newmont may hold some speculative takeover appeal. Barrick Gold, whose key mine is very close to Newmont's in Nevada, had been negotiating a merger with Newmont, but nothing materialized. If gold prices stay low longer, look for consolidation to allow these companies to reduce costs.

8. Goldman Sachs (GS)

Goldman is one of best brand names in financial services; like IBM in technology, nobody got fired for hiring Goldman. Recent regulatory developments in the wake of the financial crisis have forced much of the competition to restructure or exit.

Goldman, like most financials, will benefit from an eventual higher interest rate environment. That may spur more trading and increase interest in the all-important fixed income business.

Some have questioned the future profitability of brokers like Goldman in the wake of major regulatory reform, arguing that their being forced out of some businesses, like proprietary trading, will hurt. While that may well be true, it will probably have the intended effect of reducing risk, causing investors ultimately to value brokers like Goldman more highly.

Goldman has successfully handled before major changes to the business, such as decimalization, electrification, and fragmentation of the equity markets. Its global reach and scale give it an edge. Its “promote from within” culture gives it a management advantage.

Goldman’s valuation looks attractive: The stock is down nearly 12% from the beginning of year, and 1/3 from its all-time high, trading at just book value and 11 times forward earnings.

9. Coach (COH)

The company responsible for some of the globe’s hottest fashion accessories has cooled recently. That gives investors a unique opportunity to participate in its long term growth at a bargain price.

Coach’s handbags and leather items were much coveted items in fashionistas’ wardrobes. Brand mismanagement, coupled with fierce competition from Michael Kors and others, has put a drag on sales and profitability.

Recent discounting has also taken a toll, causing consumers to resist paying full price, confident that a Coach outlet store will soon provide them with a cheaper price. However, the company is mending its ways, closing underperforming locations, and upping its marketing game to regain share.

For investors, the potential gain by a successful turnaround seems to outweigh the risks. The stock trades at a four year low, and offers a near 4% dividend while you wait.

10. America Movil (AMX)

America Movil is the leader in all forms of communications in Latin America, plus holds stakes in European telecoms. Led by the world’s wealthiest man, Carlos Slim, America Movil enjoys the economies of scale inherent in such a large network.

While landline growth is moribund, wireless is surging, providing plenty of growth opportunities. America Movil is also rapidly expanding into cable broadcasting.

The company has been criticized for its monopoly position in Mexico, and there are efforts to reduce its market share. However, change will come slowly, and growth opportunities in the balance of Latin America more than offset.

The stock’s valuation has declined as investors have soured on the emerging markets. However, at just 11 times earnings and down more than 1/3 from its all-time high we believe the current quote offers an attractive risk versus reward opportunity.

Second Half 2014 Investment Picks

Investment	Symbol	6.13.14	Yield %
IBM	IBM	$182.56	2.4
Citigroup	C	$47.59	0.1
Cisco	CSCO	$24.70	3.1
Avon	AVP	$14.69	1.6
Rio Tinto	RIO	$51.60	3.7
Honda	HMC	$34.68	2.3
Newmont	NEM	$23.40	3.6
Goldman Sachs	GS	$165.89	1.3
Coach	COH	$39.37	3.4
America Movil	AMX	$19.98	1.7
Average			**2.3**

2014 Investment Picks

Investment	Symbol	12.13.13	6.13.14	%Change
Chevron	CVX	$119.90	$127.26	6.14%
American Intern'l	AIG	$49.73	$54.70	9.99%
Citigroup	C	$50.97	$47.59	-6.63%
Petrobras	PBR	$13.69	$15.87	15.92%
Deere	DE	$87.18	$90.47	3.77%
Cisco	CSCO	$20.24	$24.70	22.04%
Hewlett Packard	HPQ	$26.77	$35.16	31.34%
ASA	ASA	$11.60	$13.70	18.10%
First Energy	FE	$31.71	$34.18	7.79%
Teva	TEVA	$39.82	$51.98	30.54%
				13.90%
S&P 500		1,775.32	1936.16	9.06%